Islamic Insurance: Trends, Opportunities and the Future of *Takaful*

Edited by

Sohail Jaffer

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Foreword

This decade has witnessed a rapid evolution and expansion of the Islamic financial services industry. More recently, the international dimension of Islamic finance has gained greater significance as it has become increasingly integrated with the international financial system. Islamic finance has also experienced exceptional growth not only in the Muslim world, but also across the Western world demonstrating its competitiveness as a form of financial intermediation. Islamic finance is no longer a niche product serving a specialised market but is now offered in more than 60 countries, with total assets in Islamic banking reportedly exceeding USD500bn. Islamic mutual funds are estimated to be valued over USD300bn, while the issuance of Islamic sovereign and corporate bonds, or sukuk, are estimated to be about USD41 bn.

Increasingly, Islamic finance has evolved from the development of Islamic banking to a more comprehensive and complete Islamic financial system to include the takaful market (Islamic Insurance), non-bank specialised financial institutions, as well as the Islamic inter-bank money and capital markets. The entire chain of the Islamic financial system is important to ensure a more efficient allocation of financial and economic resources within the system and to allow for greater diversification of risks.

Regulatory and legal reforms have also been undertaken in a number of jurisdictions to accommodate the unique characteristics of Islamic financial transactions to support the progressive development of Islamic finance. The significant growth of Islamic financial markets, the development of the supporting financial infrastructure and the standardised international rules and regulations now being issued by the Islamic Financial Services Board for the Islamic financial institutions have all contributed to a robust international Islamic financial architecture for Islamic finance, thus contributing towards ensuring the stability and soundness of the Islamic financial system.

Within the progress that has been achieved in the development of the Islamic financial system, the *takaful* industry has also experienced significant achievements, indicating a clear manifestation of the recognition of Islamic insurance as an important source of enhancing the *Shari'a* compliant protection against vulnerability or risk arising from untoward events. The growth is reflected by the increase in the number of strong *takaful* and retakaful operators worldwide and the growing participation of prominent global players in the *takaful* and retakaful market. In Malaysia, the strategy to encourage alliances and collaborative efforts between local and foreign players have resulted in a positive outcome with the newly licensed *takaful* operators consisting of joint ventures and consortiums of local and foreign players registering early strong performance.

The significant growth performance of the *takaful* industry has taken place in the context of the low insurance penetration rates in most Muslim countries. Moving forward, the high

population growth, increasing affluence, and favourable demographic changes indicate a significant positive growth potential of the *takaful* industry. The future prospects on the industry will, however, require strengthening of the institutional capacity, the ability to innovate, and to achieve greater degree of operational efficiency. The strong performance must also be anchored by strong legal, regulatory and *Shari'a* frameworks governing the industry.

It is important to highlight that the key strategy for the sustainable development of the industry is the continuous enhancement of human capital to expand the source of knowledge in takaful and retakaful. This is crucial to elevate the technical expertise in this newly emerging industry, in particular, to drive innovation so as to enhance the ability to respond to the more complex and changing demands. Expertise is also required in risk management, governance structure as well as in the regulatory and supervisory framework. This is vital to sustain market competitiveness of the industry. In this connection, Malaysia has taken the initiative to establish the International Centre for Education in Islamic Finance (INCEIF), which has been granted a university status in 2006. INCEIF aims to nurture Islamic finance professionals and experts in order to address the human capital needs of a rapidly expanding Islamic financial services industry in the long term.

Against this backdrop, this book is indeed very timely as it focuses on an important component of the Islamic financial system, the *takaful* industry and on the opportunities that it offers. It is encouraging to note that many prominent takaful practitioners have contributed to this book. This sharing of experience and perspectives on the significant transformation that the *takaful* and retakaful industry had undergone for more than two decades provides valuable lessons. In particular, the papers have also drawn constructive references from the different jurisdictions. Their insights on the wide array of topics relating to *takaful* and retakaful will prove beneficial to the development process and advancement of the *takaful* and retakaful industry.

The greater understanding and appreciation of Islamic finance as a viable form of financial intermediation will contribute towards paving the way for greater dynamism and growth of the *takaful* industry in the global financial environment.

Dr Zeti Akhtar Aziz
Governor of Bank Negara Malaysia
February 2007

Introduction

In line with other types of Islamic finance products, the Islamic insurance market has experienced significant growth since the establishment of the first *takaful* operator in 1979. Research from Moody's rating agency has indicated that there are currently over 250 *takaful* companies in existence globally and projections show that total *takaful* premiums are likely to reach over US$7bn by 2015.

As an introduction to the subject, this book explores the growth and global market for *takaful* and the factors driving such growth. Although Islamic jurisdictions have traditionally had one of the lowest insurance penetration rates in the world, this book examines how the growing demand for Islamic financial services can be harnessed to develop a profitable *takaful* market for the future. It will also consider the corresponding development of the re-*takaful* industry, which is key to the growth of the direct *takaful* market. The first re-*takaful* company was established in 1985 and, although there has been a steady growth in the number of re-*takaful* operators over the past 20 years, it has not yet been able to match the surge in the number of direct providers over the same period. This has resulted in many *takaful* operators having to resort to conventional reinsurers in order to manage their risk profile. Although a number of well-known international reinsurers are obtaining licences to establish Islamic-compliant reinsurance operations around the globe, the need for Shari'a compliant reinsurance capacity remains vital.

Against this background, this book considers the different *takaful* models and mechanisms in existence. This encompasses an examination of the development of comprehensive life and non-life *takaful* products, the use of *takaful* as a wealth management vehicle as well as the common misconceptions and concerns which arise in the provision of *takaful*.

The underlying *takaful* models and mechanisms are put into context by a consideration of the business development and distribution issues which face the market. The low penetration of insurance business in Islamic jurisdictions has traditionally been attributed to factors such as poor marketing and a general lack of understanding of the available products. This book explores how these issues can be overcome by, amongst other things, retailing *takaful* in a more effective way and distributing the product through joint ventures with conventional insurers. Strategic alliances with conventional insurers and reinsurers will no doubt pave the way for increased competition in the market and will, in all likelihood, accelerate innovation within the Islamic financial arena.

The important issue of asset management within the *takaful* industry is also addressed and, in particular, the use of the sukuk market as a *Shari'a* compliant investment alternative

to the conventional bond market. In addition, there is a snapshot on the financial performance of *takaful* operators in 2006 which focuses on the road blocks to growth, the performance and operational efficiency of *takaful* operators against conventional insurers and various initiatives are mooted for the next cycle of development in the *takaful* market.

The spiritual dimension of *takaful* is also examined and it is suggested that *takaful* operators could market more effectively the spiritual benefits of *takaful* and gain a competitive advantage over conventional insurance products.

The *takaful* market also faces legal, regulatory and operational hurdles, which are compounded by the fact that the regulation of *takaful* is at different stages of development in various jurisdictions around the world. As a consequence, there is no measure of international uniformity in the regulation and conduct of *takaful* business. Developing a consistent international approach to regulation is key to facilitating the growth and global marketing of *takaful*. It is also apparent that the development of an Islamic capital and investment market together with an internationally recognised rating system will be critical to the corresponding growth and development of *takaful*. This will increase investment opportunities for *takaful* operations, enabling them to maximise returns within the parameters of *Shari'a* law. The greater availability of capital is also likely to assist the global development of the re-*takaful* market.

This book is written by professionals with extensive experience of *takaful*. It will be an invaluable guide in assisting those interested in the *takaful* market in understanding the models and mechanisms in use and the challenges and opportunities facing the *takaful* market.

Susan Dingwall
Partner, Norton Rose

Note from the Editor

Islamic Insurance: Trends, Opportunities and the Future of *Takaful*

In recent years, the Islamic insurance or *takaful* insurance industry has grown significantly as the Islamic alternative to conventional insurance and evolved from being a regional to a global business. The renaissance in Socially Responsible Investing (SRI) and customer demand for *Shari'a* compliant solutions has enhanced the community banking appeal of *takaful* related products. The *takaful* product family spans across non-life (general *takaful*), life (family *takaful*), health and pension business lines.

According to a report by Salama Islamic Arab Insurance Company in Dubai, '*Takaful* has become one of the leading segments of the financial sector across the Asian, Arab and African regions with growth rates of 10 to 30 per cent over the last couple of years. There are currently around 60 *takaful* operations in 30 countries worldwide.' The report by Salama Islamic Arab Insurance Company states that 'the global *takaful* market is expected to grow at between 15 and 20 per cent per annum.' According to the report by Moody's in August 2006,[1] total *takaful* annual written premiums exceeded US$2bn in 2005 and are expected to reach US$7.4bn by 2015. The report by Salama Islamic Arab Insurance Company further notes that "of this estimated amount, US$2bn in annual premiums would be written in GCC markets, US$1.3bn written in Asia Pacific region and an additional US$2.6bn in Europe, Turkey, China, India and the USA.'

Major markets currently include Malaysia, Iran, Pakistan, Saudi Arabia and other GCC countries. In Malaysia, the current market penetration is low. However, '*Takaful* is expected to constitute 20% of the total insurance market by 2010 (currently 6.5 per cent)' according

Exhibit 1

Global *takaful* industry overview

Country	*Takaful* Business
Arab countries	63%
Malaysia	27%
Asia Pacific countries	9%
Europe and USA	1%

Source: Salama Islamic Arab Insurance Company, UAE

to the Islamic Finance Newsletter of 5 December 2005. The Central Bank in Malaysia issued four new *takaful* licenses in January 2006 and interested parties included conventional financial institutions in Australia, Japan, Europe and the Middle East (HSBC Insurance (Asia Pacific) Holdings, Jerner Asia and Wang Simpanan Pekerja; Hong Leong Bank, Millea Asia, Japan and Hong Leong Assurance; Bank Simpanan Nasional and Prudential Holdings; and MAA Holdings and Solidarity). Recently, Allianz launched life and non-life *takaful* products in Indonesia and Allianz Indonesia expects growth of more than 30 per cent in this segment over the next two years.[2] The GCC states will see a dramatic increase in *takaful* in the coming years. According to the report by Salama Islamic Arab Insurance Company, 'the introduction of compulsory health insurance for expatriates from 1 January 2006 and motor third party liability in Saudi Arabia is an important trend in the Gulf. In the UAE, health insurance will also be made compulsory for foreigners, providing considerable sources of revenue to *takaful* companies.' In October 2006, the Council of Ministers in the Kingdom of Saudi Arabia licensed 13 new insurance companies most of which are joint ventures with foreign partners and several more applicants are in the pipeline. American Insurance Group (AIG) launched a regional *takaful* company, AIG Takaful, based in Bahrain. AIG Takaful will provide a range of *takaful* products, including accident and health, motor, personal contents, property and casualty.[3] The US and Europe offer considerable untapped expansion potential for the *takaful* industry.

Currently, general *takaful* (non-life) business has a dominant market share of the overall product mix in Iran and the Middle East region. According to the report by Salama Islamic Arab Insurance Company, 'approximately 52 per cent of the projected total annual *takaful* premium would be non-life (general *takaful*) with an impressive gain with life/family *takaful* segment increasing to US$4.9bn. Malaysia and Indonesia will continue to be at the forefront of the *takaful* business with over US$1.4bn in premiums. The Saudi market within the GCC has attracted several new market entrants and with the liberalisation of foreign ownership in the UAE and other markets in the insurance sector, it will further accelerate growth. Among the GCC states, Saudi Arabia is expected to generate close to US$900m in premiums, followed by the UAE (US$480m) and Egypt (US$467m).'

As the *takaful* industry develops, it needs to obtain *Shari'a* compliant reinsurance (re-*takaful*) products and capacity to direct *takaful* operators for risk transfer purposes. Millea Asia, a wholly owned subsidiary of Millea Holdings Inc, established Tokio Marine Nichido Re-Takaful (TMN) in Singapore in 2004. TMN is the first re-*takaful* specialist company established by a major international insurance group.[4] The Arab Insurance Group (ARIG) in Bahrain established Takaful Re, the first reinsurance company to be organised and operated in a fully *Shari'a* compliant manner in the Dubai International Financial Centre (DIFC) with an authorised capital of USD 500 million and an issued and paid-up capital of US$125m.[5] The Central Bank of Bahrain granted a licence to Hannover Re in September 2006 to establish an Islamic reinsurance company in Bahrain, which will focus on general and life classes. The new firm, Hannover Re Takaful, will be a wholly-owned subsidiary of Germany's Hannover Re and will have a paid-up capital of BD20m (US$53m). Hannover Re Takaful will be the principal underwriter of Hannover Re's worldwide re-*takaful* business.[6] The Central Bank of Malaysia granted three re-*takaful* licenses to conduct general and family re-*takaful* business, to inter alia Munich Re.[7] Other Islamic reinsurance companies include Best Re in Tunisia

and ASEAN Re-Takaful International in Labuan, Malaysia. Lloyd's insurer, Creechurch Underwriter Limited, has created in partnership with Salama Islamic Arab Insurance Company the first *takaful* syndicate with an initial underwriting capacity of £41m. The *takaful* syndicate will benefit from the same security rating provided to all Lloyd's Syndicates provided by Standard & Poor's, AM Best and Fitch.[8]

Due to the ethical guidelines underpinning Islamic banking, investment and finance, the increasing transparency of customer terms and conditions, the pricing structure, regular monitoring for compliance by the *Shari'a* boards, major *takaful* providers need to enhance their capacity to innovate, carefully review and understand evolving customer and market specific needs, carefully re-engineer their product design and customer benefits package. For example, an area of considerable growth in the GCC, in particular the UAE, is the real estate and home finance market. Tamweel and Amlak's home finance products and services have made a significant impact in this context. Tamweel's recent 'Yusr product' is one of the world's first *Shari'a* compliant adjustable repayment mortgage finance that allows customers to make lower monthly repayments in the initial years and amortise the difference over the remaining years of the repayment period. The expansion of the *Shari'a* compliant home finance market has also spurred the growth of *takaful* mortgage protection products with Aman Insurance taking the lead in this product line within the UAE.

The *takaful* industry has been successful in distributing products through its agency salesforce, direct channel, e-commerce and to a limited extent via certain retail banks. Several enterprising banks have included bancassurance in their product offerings (for example, the *takaful* joint venture between Prudential Plc and Bank Simpanan Nasional Bhd in Malaysia in August 2006 to create Prudential BNS Takaful Bhd which will leverage on the banks' network to offer *takaful* products to the banks' customer base[9]) and some of the new operators are offering general *takaful* products online. The distribution of *takaful* life and savings products through bank channels is largely new, but the sales process through the bank branching network has been facilitated by the advent of web based point of sale and online administration systems. In 2006, the Abu Dhabi Commercial Bank (ADCB) in the UAE successfully launched its 'Meethaq' *takaful* and savings programme designed to meet the lifecycle financial planning needs of its consumer segment. The product design has several innovative features and the delivery is supported by FWU's internet based point of sale and administration system that provides for customer convenience. The major *takaful* operators are well positioned to expand their cross-border distribution reach across multiple distribution channels including but not limited to international bank distribution channels and corporate group plan sponsors. Product customisation for the different bank channels (retail, mass affluent and private banking), customer referrals and gaining brand loyalty are critical success factors. Product packaging, customer convenience, customer care and transparency of terms, conditions and pricing are also important catalysts to increase the share of the *takaful* business across multiple distribution channels. The ability to tailor suitability diversified risk reward investment portfolios, select top quartile performing funds from major international brands and control defined portfolio risk levels are powerful drivers for the retail value proposition. Furthermore, the product certification by an independent *Shari'a* board of experts and ongoing compliance monitoring with high ethical standards has favourably impacted transparency and disclosure of terms and conditions, charges and frequency of reporting.

The legal and regulatory landscape of the *takaful* industry is at its infancy. In an integrated global financial services market, one of the challenges faced by the cross-border *takaful* players includes the development and harmonisation of the prudential regulation and supervision at an international level of the *takaful* and re-*takaful* industry. The Central Bank of Bahrain recognised the need to introduce comprehensive regulations to foster the industry's growth and as a result introduced regulations for the Islamic insurance and reinsurance industry which form part of the CBB's Insurance Rulebook in 2005. Furthermore, according to the BMA Insurance Review of October 2005, 'work on a global standard on *takaful* has reached an advanced stage. The International Financial Services Board (IFSB) and the International Association of Insurance Supervisors (IAIS) are developing the standards jointly. The issues paper on *takaful*, presented by the joint working group, provides a detailed insight into the background of *takaful*, the need for a standard, the relevance of IAIS core principles to *takaful*, governance issues (such as the roles of the *Shari'a* boards), financial and prudential issues, market conduct issues and supervisory skills and training. The BMA[10] has recently pioneered a comprehensive regulatory framework specific for the *takaful* business. The framework, issued in May 2005, takes into consideration the unique characteristics of Islamic insurance.' The Bank Negara Malaysia's Deputy Governor noted in a Keynote Address at the 2nd Seminar on Regulation of *Takaful*: 'A joint working group comprising representatives from IAIS and IFSB has been formed to assess the applicability of the IAIS insurance core principles for *takaful*. The joint working group has made significant progress through the issuance of an Issue Paper on Issues in Regulation and Supervision of Takaful. The Issue Paper has identified four major areas that require immediate attention. These are the corporate governance, financial and prudential regulation, transparency, reporting and market conduct as well as supervisory process, which may lead to the issuance of a specific guidance paper or standard that corresponds with the IAIS insurance core principles'.[11]

Against this backdrop, this publication is timely. It draws together the insights and experience of a wide range of knowledgeable and prominent market practitioners, renowned *Shari'a* scholars and academics, major *takaful* and re-*takaful* providers, wealth managers, international actuaries, consultants and lawyers and leading regulatory authorities. Their contributions have been organised into four parts:

- Introduction to *takaful*
- The *takaful* models and mechanisms
- The business development and distribution issues
- Legal, regulatory and operational issues

I wish to thank each one of the authors for their valuable contribution, time, encouragement and dedication. Their wealth of knowledge and expertise is impressive and I am grateful to them for sharing it with us. I wish to express my sincere appreciation to Dr Elizabeth Gray and Sanjeevi Perera, Commissioning Editor at Euromoney Books for their excellent cooperation, review and assistance in accomplishing this unique and important project. I also wish to thank Kamar Jaffer for her invaluable research, review assistance and overall contribution to enhancing the quality of this interesting and timely publication.

Conclusion

The global *takaful* industry is relatively small compared to its conventional insurance counterpart and the current *takaful* market size is estimated between US$2.5bn to US$3.5bn of annual premium. It needs to gain critical mass, build worldwide brand recognition and exceed performance standards set by the conventional insurance industry. There are only a few international *takaful* suppliers. The major challenges include the development and harmonisation of the regulatory framework for the *takaful* industry, creating suitable *Shari'a* -compliant investment securities, raising customer awareness and education, product innovation and marketing, gaining brand recognition, offering attractive investment choices to customers in family *takaful* linked investment plans, optimising the use of technology to enhance customer aftercare, widening penetration of bank and alternative distribution channels and creating strongly capitalised global re-*takaful* and multiline *takaful* providers.

There are significant untapped new growth opportunities for Islamic insurance products in the US, Europe, the Middle East and Asia. For example, the Syrian Insurance Supervision Committee has granted in-principle approval to the Syrian Qatari Insurance Company, the Nour Insurance Company and Al Aqila Insurance Company to provide Islamic insurance products in an emerging market estimated at US$500m.[12] There is also scope for GCC and international cross-border players to package premier products and services to their middle income and affluent customers and process these through major bank distribution and other financial intermediaries. Primary markets within Europe that have a sizeable Muslim population include the United Kingdom, France and Germany. In Asia, China, India and Indonesia also offer opportunities. Islamic centres of product excellence include Malaysia, Bahrain and the UAE but Indonesia, Saudi Arabia and Pakistan are fast evolving and building their product expertise in this important business segment. In addition, *takaful* companies may now obtain a financial strength rating from international rating agencies such as Moody's which provides fund members adequate financial security, corporate governance practices and risk management systems.[13] The major regional and international players such as Dubai Islamic Bank, National Commercial Bank, Kuwait Finance House, Citigroup, Mayban and Bank Mandiri are well positioned to export and adapt their distribution capabilities and customer-centric value proposition to the mature regulatory, tax and accounting regimes of the major OECD jurisdictions. Global insurance brands such as AIG, Prudential Plc, AXA, Allianz, Munich Re and Hannover Re have recently entered the *takaful* or re-*takaful* business. Similarly, the international bank distribution partners such as HSBC are expanding their community banking offering to including *takaful* solutions for their individual and corporate customers.

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1 Moody's report entitled "*Takaful*: A Market with Great Potential" dated August 2006.

2 Allianz press release dated 24 January 2006.

3 Central Bank of Bahrain's Insurance and *Takaful* Review dated October 2006.

4 Millea press release dated 1 December 2004.

5 ARIG press release dated 19 September 2005.

6 CBB press release dated 11 September 2006.

7 Middle East Insurance Review dated November 2006 (page 59).

8 Insurance Journal entitled "Lloyd's Creechurch Creates Syndicate to Conform with *Shari'a* Law" dated 6 January 2006.

9 Prudential PLC press release dated 8 August 2006.
10 The Bahrain Monetary Agency ('BMA') is now known as the Bahrain Central Bank.
11 Bank Negara Malaysia's Deputy Governor noted in a Keynote Address at the 2nd Seminar on Regulation of *Takaful* in Malaysia on 23 February 2006.
12 Middle East Insurance Review dated November 2006 (page 59) and AME Info – Middle East Finance and Economy Article: "Syria licenses first *takaful* insurance companies" dated 20 September 2006.
13 Moody's report entitled "*Takaful*: A Market with Great Potential" dated August 2006.

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Author biographies

About the Editor

Sohail E Jaffer is a Managing Director of Premium Select Lux SA, an asset management subsidiary of the FWU Group. The company is based in Luxembourg and specialises in Multimanager and Quant based investments. He is also a Partner and the Head of International Sales and Distribution for 'white label' bancassurance, bancatakaful and asset management services within the FWU Group, an independent financial services group headquartered in Munich. The Group's main activities include asset management, bancassurance and individual pension plans. He successfully concluded several major bank distribution deals. The Group's branch network includes Luxembourg, Italy, UAE and Malaysia.

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He later joined Citibank's Alternative Investment Strategies Group which formed part of Citibank Global Asset Management. He was a Director and his responsibilities included international business development and the distribution of multistrategy hedge funds and collateralised high yield debt (CDO) funds to institutional investors and financial intermediaries in Europe and the Middle East region. He was also a member of Citi's Hedge Funds Policy and Strategy Committee that was responsible for the fiduciary oversight of hedge fund managers selected.

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About the Contributors

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Ajmal Bhatty holds the position of Director and Global Head of Takaful at HSBC Amanah since 2003, based in Dubai, responsible for developing takaful business for the Group. Before HSBC, he was CEO of Takaful International Bahrain. His other professional activities and achievements have been Takaful advisor to the Bahrain Monetary Agency, author of initial

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Susan Dingwall is a partner in the insurance and reinsurance group at the international law firm, Norton Rose, which has a leading Islamic finance practice. She has over 20 years' experience of the international insurance and reinsurance markets and is recognised as a leading insurance and reinsurance dispute resolution lawyer. Susan's practice covers a diverse range of disputes in the international marine, non-marine and aviation markets. She also has an extensive practice in policy drafting and advises major insurers and reinsurers on market wordings and bespoke specialist forms. Susan has considerable experience of the Middle East insurance markets,

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Keith Driver is CEO of HSBC Amanah Takaful (Malaysia). He joined HSBC in 1989 and has spent his 18 year career living and working in South East Asia, the Middle East, Central Asia and the UK covering a variety of functions: Retail and Corporate banking, Securities Custody, Strategic Planning, Islamic Finance, Insurance, new market entry and start-up operations. He is a frequent speaker at conferences on Islamic finance and *takaful*. Keith was born and grew up in USA and graduated from University of Delaware (International Relations) and attended London School of Economics (Economic History).

Adam Ismail Ebrahim is CEO of Oasis and Head of Investment and was educated at the University of Cape Town in South Africa, where he received his BSocSc (Hons) degree. Thereafter he completed a Postgraduate Diploma in Accounting and was admitted as a Chartered Accountant and Auditor in South Africa. Following the completion of his qualification as a chartered accountant, Adam completed the Association for Investment Management and Research's Chartered Financial Analyst Programme, qualifying as a Chartered Financial Analyst. Adam has worked for Deloitte & Touche in South Africa and in London and has also gained work experience as an analyst, portfolio manager, director, and partner of a prominent asset management organisation. He is registered as a Portfolio Manager with the Financial Services Boards (South Africa), and currently serves as a member of the South African Minister of Finance's Collective Investment Scheme Advisory Committee

Omar Clark Fisher is Senior Director and Head of Takaful Business Development at Unicorn Investment Bank, BSC (c), Bahrain. He has over 26 years of financial services experience spanning international project finance, Islamic leasing, political risk guaranties and *takaful* (Islamic) insurance. Prior to UIB, he was Deputy Head, Takaful Taawuni at Bank Aljazira from 2000 until 2004 where he launched the first Life Takaful business in Saudi Arabia. He was also Founder and Chairman, First Takaful USA from 1997 until 2000, Founder/ COO of BMIL from 1992 until 1994. Mr Clark is the author of numerous articles as well as an internationally accepted Takaful Training Manual. He recently authored an interactive guide on *Wealth Creation, Risk Management and Wealth Distribution in accordance with Islamic Shariah*. Mr Fisher's education ranges from Yale University (BA) to a PhD in Takaful jointly conferred in November 2005 by the International Islamic University of Malaysia and Camden University (USA).

Shankar Garigiparthy is Associate Director of Supervision within the Qatar Financial Centre Regulatory Authority and is responsible for the supervision of insurance companies within the QFC. Prior to joining the QFC Regulatory Authority in November 2005, he spent 7 years working for Lloyd's of London, where he was responsible for the admission of corporate members to the Society of Lloyd's. He was also responsible for devising the policy to attract reinsurance participation at Lloyd's by way of a quota share reinsurance mechanism. He also spent 5 years as a portfolio manager at Barclays Stockbrokers in England, where he was

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Bassel Issam Hanbali is Head of Marketing of Solidarity, one of the largest *takaful* companies worldwide with US$275 million in paid up capital, leads the company's international marketing team with the key objective of strengthening the organizational brand image and maintaining awareness, recognition and attractiveness of the products among the targeted groups. Hanbali has held a number of key marketing positions with several international organizations in the UAE and previously Lebanon. Where he received his BS in Business and Marketing from the Lebanese American University, followed by an MSc in Marketing Communication Management from the University of Surrey (SEMS), UK. He is an Associate of the Charter Institute of Marketing (CIM) and a Postgraduate Diploma holder in Marketing from the same. Bassel has extensive international Marketing experience that offered him the chance to speak in several world class financial conferences and educational institutions addressing major communication issues and highlighting suitable marketing solutions for today's Islamic financial services industry.

Douglas Clark Johnson is CEO and Chief Investment Officer of Calyx Financial, a Wall Street-based firm specialising in serving overseas clients, with an emphasis on the Islamic world. The firm has created the first globally-sourced, multi-asset-class fund of *Shari'a* compliant funds, distributed in partnership with selected financial institutions throughout the Islamic world. Mr Johnson founded Calyx Financial in 2002 after serving as managing director of global allocation services for the international investments division of Prudential Financial. From 1988 to 1998, he held senior portfolio management and international securities research positions with Merrill Lynch in New York. Mr Johnson holds dual master's degrees in finance and international affairs from Columbia University.

Zainal Abidin Mohd. Kassim is a consulting actuary, has consulted to *takaful* companies in Asia, Middle East, North Africa and Europe and is familiar with the various *takaful* models used around the globe. He has been a consulting actuary for 25 years during which time he has consulted to companies in conventional life and general insurance, in addition to *takaful*. His *takaful* experience started in 1985 when he was appointed actuary to the first *takaful* operator in Malaysia. He is currently actuary to several *takaful* companies in Malaysia. Zainal graduated from City University, London in 1978 with a first class honours degree in Actuarial Science. He is a Fellow of the Institute of Actuaries in England and an Associate of the Society of Actuaries in the USA. Zainal is Principal and Actuary at Mercer Zainal Consulting Sdn. Bhd. and is based in Kuala Lumpur, Malaysia.

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Mohd Tarmidzi bin Ahmad Nordin is the CEO of Takaful Nasional Sdn Berhad. He has previously held roles as CEO of Maybank Takaful Berhad and Director of Loss Adjusters. He was one of the founder members of the first *takaful* company in Malaysia, Syarikat Takaful Malaysia. Mohd Tarmidzi Bin Ahmad Nordin has lectured on insurance in Malaysia and Indonesia. He holds an MBA from the International Islamic University, Malaysia, where he majored in Islamic Finance.

Andrew Smith is Head of Operations for The Saudi British Bank (*takaful*) based in the Kingdom of Saudi Arabia. In addition to his role as head of operations, he also responsibility for information technology and property. Previously he held the position of Head of Sales for Solidarity BSC (c) based in the Kingdom of Bahrain. He holds the post-graduate diploma from the Islamic Institute and Banking and Insurance, London, where he is also an Associate member. He is currently finalising the dissertation for his Masters MSc in Training, Development and Performance Management from Leicester University, United Kingdom. He has worked in the Middle East for a number of years, and previously held a number of key positions in the United Kingdom financial services industry. He has been a speaker at a number of conferences on *takaful*, including The World Islamic Banking Conference (Bahrain) in 2004, and the First Islamic Takaful Symposium (Jordan) 2005.

Kirk B Smith is a Principal and co-founder of the marketing advisory firm Smith Mumford & Co., and has 20 years' experience in management and marketing consulting. Previously he served as a senior policy analyst at the Foundation on Economic Trends in Washington, DC, and as an investigative reporter in regional journalism. Mr Smith studied political science at Empire State College of the State University of New York. He has done postgraduate work in survey research and quantitative methods at the New School for Social Research and the Rockefeller Institute of Government.

Rodney Wilson is Director of Postgraduate Studies at Durham University's Institute for Middle Eastern and Islamic Studies and a Professor of Economics. He has worked for the Islamic Development Bank in Jeddah, and currently chairs the academic committee of the Institute of Islamic Banking and Insurance in London. He teaches masters level courses on

Islamic economics and finance and has supervised over 30 PhD students working on Islamic finance. He has acted as Course Director for Euromoney Training in London, Kuwait, Bangkok and Singapore, and taken courses for the Kuwait Investment Authority, the Commercial Bank of Kuwait, the Arab Banking Corporation, Citibank and the Monetary Authority of Singapore. Professor Wilson has also written and contributed to a number of publications on Islamic finance. www.dur.ac.uk/sgia/profiles/?mode=staff&id=498

Part I

An introduction to *takaful*

Chapter 1

The growth and global market for *takaful*

Ajmal Bhatty
HSBC Amanah

Introduction

To witness interesting challenges and opportunities in the field of insurance, *takaful* or Islamic insurance is the space to watch and the field with which to be involved. This view is certainly in the minds of many entrepreneurs and insurance practitioners around the world who have witnessed the growth of *takaful* since the mid-1990s. Numerous papers and articles have been written on the growth and size of the market in *takaful* and each of these has fallen out of date very quickly. The paces of growth and supply of *takaful* have been striving to catch up with the unlocking of pent-up demand. It has been a delight to witness the phenomenon of demand triggering this much activity on the supply side, as new companies discovered the extent of latent demand. Numerous research studies have been conducted over several years, and many have highlighted the difficulties of turning this latent demand into something tangible. It is most fulfilling to note that whilst it is relatively easy to critique the possibilities of *takaful*, those who believed in the demand for Islamic products persevered and took the steps to commit their capital in green field *takaful* projects and initiatives, and have been proven right. The momentum created by the growth in *takaful* has eventually been reason enough for critics of *takaful* to join in the development of the *takaful* industry.

This chapter is a synopsis of the size of the global *takaful* market at a point in time (2006). As it is rather difficult to source information on this subject, it is hoped that this chapter may prove to be a useful reference point on this subject. The sources of data for this paper have been Sigma publications of Swiss Re, the Arab Insurance Group and the author's own research efforts in acquiring data directly from the industry. The projections and estimates are based on the author's understanding of the *takaful* market, interpretation of past trends and changes due to on-going developments and current understanding of the future prospects.

The *takaful* industry

The term '*takaful* industry' refers to all operators involved in the business of *takaful* products and services. The industry consists of direct insurance-writing companies offering a full range of *takaful* products, conventional insurance companies offering a limited range of *takaful* products and re-*takaful* and reinsurance companies. Increasingly, banks are becoming active

players in *takaful* through ownership of *takaful* businesses, and distribution of *takaful* products. Reinsurance brokers, insurance syndicates and fund managers are also active in the *takaful* business.

Typically, *takaful* reflects products based on certain defined rules and processes in line with the *Shari'a* principles, such as *wakala* and mudaraba models, rules governing investment and management of funds, and cooperative principles of sharing risks and rewards (commonly known in the *takaful* industry as profit sharing). Most objections to conventional insurance came from the Sunni juristic school of thought. This generated debate in the 1970s and 1980s in order to find an acceptable solution to financial risk management. This resulted in subsequent consensus on a *Shari'a* compliant insurance model to be established on cooperative principles that we now know as *takaful*. Although there were fewer objections to conventional insurance within Shi'a jurisprudencial thought, there is a general acceptability of *takaful* amongst Muslims from both schools of thought (Shi'a and Sunni). The *takaful* industry should therefore be able to expand into countries where either school of thought dominates.

In the mid-1990s, the *takaful* 'industry' was made up of just a handful of companies. With a few exceptions, most *takaful* operators were struggling to compete, equipped with a limited product range and very few investment opportunities to match insurance-related *takaful* liabilities. By the mid-2000s, there are an increasing number of players and the universe of Islamic insurance is growing strongly, both professionally and competitively, thanks partly to the continuing growth in the range of Islamic investments relevant to insurance.

The growth of the *takaful* industry

The *takaful* industry finds itself in the mid-2000s poised for a quantum leap, as we witness a growing number of players, both big and small, entering the market. We have moved past the milestone of 'perception' and are now very much in the 'realisation' zone of *takaful* potential. Industry leaders have been busy laying the foundations for building this industry on ethical and fair principles, guided by the laws of the *Shari'a*. The *takaful* industry is now at the critical point of having understood the virtues of a *takaful* system, and is beginning to work with real numbers and underwriting profits for providing good durable returns to both customers and shareholders alike.

A study was undertaken by the author in 2003–4 to establish the size of the *takaful* industry in 2002 and to project its size in 2015 in terms of *takaful* contributions or written premiums. These estimates have not been updated since and the 2002 estimates are quoted in Exhibit 1.1. The data and projection model is built from the author's own research work including sources from Swiss Re Sigma and the Arab Insurance Group.[1]

The estimated global *takaful* premiums (or contributions) were US$1.3bn in 2002, although this excludes premiums in Iran. Including Iran, the figure was US$2.1bn. It is estimated that about 40 per cent of global *takaful* business relates to family *takaful* or *Shari'a*- compliant life assurance. In 2002 there were an estimated 41 companies offering Islamic insurance (either as *takaful* companies or through Islamic windows) in some 23 countries around the world. Of this, the institutions offering *takaful* through Islamic windows were estimated to be only 5 per cent of the total. The number of *takaful* companies more than doubled to 87 in four years (by mid-2006) across 29 countries. *Takaful* windows represent 36 per cent of

this number, showing a growing trend of conventional companies wishing to enter this industry, either as defensive moves to protect their existing market share, or to genuinely increase the market share for *takaful* products. The position in 2006 is shown in Exhibit 1.2.

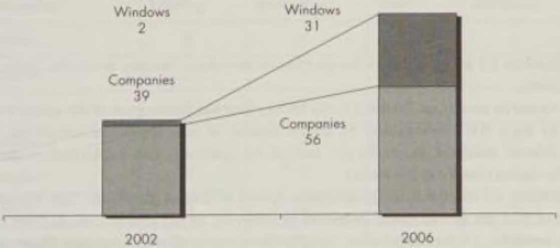
Exhibit 1.1

Global takaful in 2002* (US$bn)
***(revised estimates, 2003)**

Source: Author's own

Exhibit 1.2

***Takaful* windows and companies, 2002–2006**



Source: Author's own

Exhibit 1.3

Number of *takaful* companies in the Middle East, July 2006

Islamic insurance companies	Existing	In formation	Total[1]	Existing windows
Saudi Arabia	1	13	14	0
Bahrain	3	1	4	0
Iran	5	0	5	0
Kuwait	5	1	6	0
Qatar	2	0	2	0
Oman	0	1	1	0
United Arab Emirates	4	1	5	1
Yemen	1	0	1	0
Jordan	1	1	2	0
Lebanon	1	0	1	0
Middle East (total)	**23**	**18**	**41**	**1**

1. Inclusive of windows
Source: Author's own

Exhibits 1.3 to 1.6 illustrate the position in the *takaful* industry across the globe, as at mid-2006.

As can be seen from Exhibit 1.3, the Middle East has shown most of the entrepreneurial activity since 2002, establishing the largest number of fully-capitalised companies, rather than Islamic windows. Some 80 per cent of the windows were established in the Asia Pacific region (mostly in Indonesia).

Exhibit 1.7 illustrates the geographical spread of *takaful* premiums. This represents a share of 37.5 per cent of global premiums in Malaysia, 39 per cent in Iran, 20.5 per cent in Arab countries, 2.6 per cent in other Asia Pacific countries (that is, other than Malaysia) and 0.2 per cent in Europe. In Malaysia and other Asian Pacific countries (Indonesia, Singapore and Brunei), the family *takaful* and personal lines business has grown at a much faster rate, with overall *takaful* premium income predominantly derived from these product lines.

Exhibit 1.4

Number of *takaful* companies in Africa, July 2006

Islamic insurance companies	Existing	In formation	Total[1]	Existing windows
Tunisia	1	0	1	0
Egypt	1	0	1	0
Sudan	12	0	12	0
Ghana	1	0	1	1
Niger	1	0	1	1
Senegal	1	0	1	0
Africa (total)	**17**	**0**	**17**	**2**

1. Inclusive of windows
Source: Author's own

Exhibit 1.5

Number of *takaful* companies in the Asia Pacific region, July 2006

Islamic insurance companies	Existing	In formation	Total[1]	Existing windows
Malaysia	5	4	9	0
Singapore	2	0	2	1
Brunei	3	0	3	0
Indonesia	23	0	23	22
Australia	1	0	1	1
Thailand	0	1	1	0
Asia Pacific (total)	**34**	**5**	**39**	**24**

1. Inclusive of windows
Source: Author's own

Exhibit 1.6

Number of *takaful* companies in the rest of the world, July 2006

Islamic insurance companies	Existing	In formation	Total[1]	Existing windows
Pakistan	1	1	2	0
Bangladesh	6	0	6	0
Sri Lanka	1	2	3	0
UK	1	1	2	1
Luxembourg	1	0	1	0
Trinidad & Tobago	2	0	2	2
Russia	1	0	1	1
The Rest of the world	13	4	17	4
Total	87	27	114	31

1. Inclusive of windows
Source: Author's own

The Malaysian market has grown at a staggering rate of 79 per cent per annum in family *takaful* over the period 1995 to 2001. The five-year compound annual growth rate (CAGR) for conventional life insurance in 2004 was 19 per cent per annum in Malaysia, 33 per cent per annum in Saudi Arabia and 7 per cent per annum in Jordan. The dramatic growth in Saudi Arabia is likely to be sustained in the *takaful* business sector, as new locally licensed companies start writing *takaful* business from 2007.

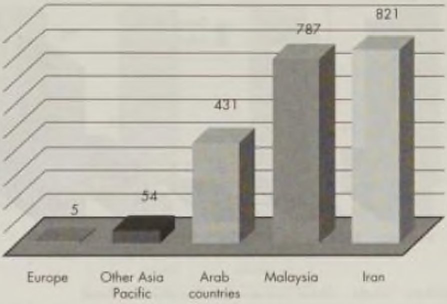
Which *takaful* products are available and where?

The product shelf of *takaful* is more comprehensive in general *takaful* than family *takaful*. It was not until the late 1990s and the early part of 2000 that more emphasis was given to the development of the family *takaful* business lines. There are a number of reasons as to why family *takaful* lagged behind general *takaful*.

- A mind-set that conventional insurance was unacceptable on religious and cultural grounds had more of an adverse impact on family *takaful* than on general *takaful*.

Exhibit 1.7

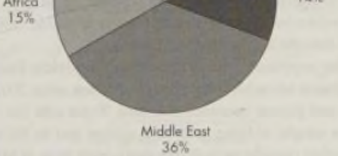
Global *takaful* premiums, 2002 (revised estimates, 2003)



Source: Ajmal Bhatty, '*Takaful* – Global Overview and Opportunities Ahead'[7]

Exhibit 1.8

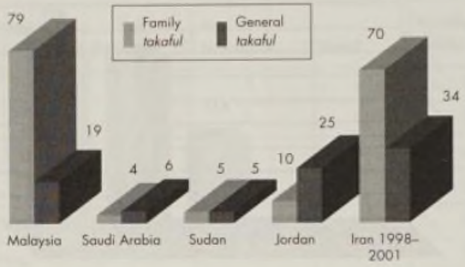
Geographical spread of *takaful,* by number of companies, July 2006



Source: Author's own

Exhibit 1.9

The annual growth of family *takaful* verses general takaful (%): 1995–2001



Source: Ajmal Bhatty, '*Takaful* – Global Overview and Opportunities Ahead'

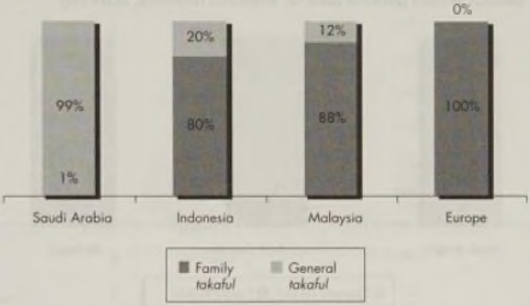
- General insurance acceptance was easier as a necessity to protect businesses and assets. Life insurance appeared to be more of an intangible benefit and there was more of a perception that it was a wager on life.
- Companies were better resourced with local talent to handle general insurance, with a lot of support from foreign insurers, brokers and reinsurers.
- The range of Islamic investments was short term and very limited, thus not entirely suitable for developing long-term liability products. It was not until perhaps the year 2000 that Islamic fund management activity accelerated, providing a reasonable range of possibilities to develop long-term products.

In most Arab countries, family *takaful* was written in less than 1 or 2 per cent of the total, compared with 5 per cent or more in life insurance. Malaysia addressed the issue of family *takaful* early, as did, in a limited way, some countries in Europe (Germany, France, Belgium and the UK) mainly through the efforts of one company based in Luxembourg. Exhibit 1.10 illustrates the extent to which family *takaful* formed part of the total portfolio. It does not indicate the volumes written but the 100 per cent of family *takaful* in Europe actually represents much lower volumes than the 88 per cent in Malaysia.

Family *takaful* has experienced better growth in the Middle East since 2002, and the *takaful* business in general has achieved a good momentum since 2001. The global average mix of life insurance and general insurance is around 70 per cent life / 30 per cent non-life. Most countries where *takaful* is being sold have a large gap to fill as family *takaful* still constitutes a small portion (usually up to 20 per cent), apart from in Malaysia, Indonesia and some European countries. Exhibit 1.12 illustrates this in selected markets in 2004. The Malaysian *takaful* market is fast changing and is likely to experience much faster growth than

Exhibit 1.10

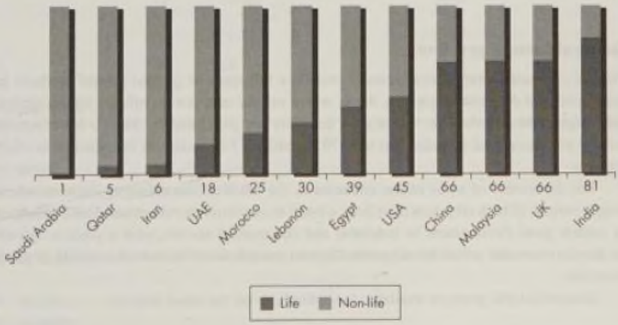
Family *Takaful* verses general *takaful*: selected, markets 2001



Source: Author's own

Exhibit 1.11

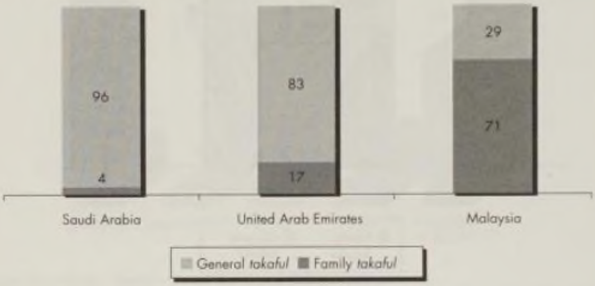
Life insurance verses general insurance, selected markets, 2005 (%)



Source: Author's own

Exhibit 1.12

Family *takaful* verses general *takaful*, selected markets, 2004 (%)



Source: Author's own

it has to date. The Malaysian *takaful* regulator is very much committed to supporting the development of the *takaful* industry. The impressive growth rate of some 18.8 per cent per annum over a period of five years (2000 to 2004) has managed to secure market penetration of around 5.6 per cent (the total number of policies in force divided by the total population). The stated objective is for *takaful* to achieve a conventional penetration rate of at least 38.7 per cent.

General *takaful* products

Takaful companies everywhere typically provide a full range of general *takaful* products in both retail and corporate segments. Areas where *takaful* may not be offered are breweries, bars, nightclubs and the like, where such activities are prohibited by *Shari'a* law. General *takaful* was introduced in Sudan first in 1979. Exhibit 1.13 illustrates its introduction in other markets.

The economies of some of the countries in the Middle East are energy-driven, where longer periods of high oil prices have been a boost to economic development. This has helped to sustain good development in industrial and commercial sectors, with a positive impact on employment and social development. General *takaful* therefore features heavily in these countries.

General *takaful* products available for individuals on the retail side are:

- personal accident;
- travel;

Exhibit 1.13

First offering of general *takaful* products (year)

1	Sudan	1979
2	United Arab Emirates	1980
3	Luxembourg	1982
4	Saudi Arabia	1983
5	Malaysia	1984
6	Bahrain	1989
7	Brunei	1993
8	Indonesia	1994
9	Qatar	1995
10	Singapore	1995
11	Jordan	1996
12	Sri Lanka	1999
13	Kuwait	2000
14	Bangladesh	2000
15	Pakistan	2003
16	Yemen	2004
17	Egypt	2004
18	UK	2005

Source: Author's own

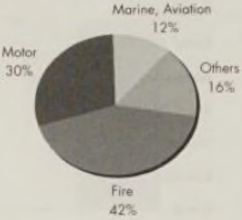
- motor;
- home buildings and contents; and
- medical and health.

Takaful products for businesses and assets are offered in the following areas:

- marine;
- aviation;
- fire; and
- engineering.

Exhibit 1.14

General *Takaful* products: typical mix, 2004 (%)



Source: Author's own

Major risks in the oil and energy areas are still placed conventionally, primarily for reasons of underlying security.

The generic products listed above are packaged in various ways to provide the following:

- financial services blanket cover;
- professional indemnity *takaful;*
- loss of profit *takaful;*
- public liability *takaful;*
- employers' liability *takaful;*
- material damage *takaful;*
- money *takaful* (money in transit and safe);
- fidelity guarantee *takaful;*
- leasing of plant and machinery *takaful;* and
- credit protection *takaful.*

Family *takaful* products

Almost all *takaful* operators offer *Shari'a* compliant group life cover or group *takaful*. This is a one-year renewable cover that fits easily within the short term insurance / *takaful* business. In fact, in many of the Arab countries where the mix of family *takaful* business is 1 per cent or lower, group *takaful* is the main or only component. In other markets such as Malaysia, Indonesia and Singapore, several types of family *takaful* products are available related to savings and protection. Family *takaful* was introduced into Sudan, Luxembourg (for Germany, France, UK) and Malaysia in the early 1980s (1984 in Malaysia, Qatar in 2001 and Bahrain in 2002). Qatar registered US$0.9m in the first year of business.

The Gulf States show very good family *takaful* potential for the medium term. There has been growing realisation of the real and serious issues caused by a young demographic profile and its impact on public funding. This is especially so where the state has been the biggest employer for the growing number of young graduates annually leaving universities. Governments in countries such as the United Arab Emirates, Kuwait, Saudi Arabia and Bahrain, in pursuit of cutting expenditure, have introduced statutory health insurance. This is compulsory for foreign workers, but the trend is that it will also be applicable to the local population. This, together with the potential for family *takaful* to grow, is expected to boost the growth of insurance manifold in this region over the coming years.

The following are typical family *takaful* products offered:

- family *takaful* – level-term assurance;
- home finance *takaful* – mortgage related reducing-term assurance;
- savings and education plans – mostly unit-linked funds with family *takaful* wrapper;
- retirement plans – contribution-defined savings schemes with specific funds providing minimum returns together with the possibility of growth through equity-based instruments (offered in a limited way in Malaysia and the Middle East);
- ancillary benefits added to the main plans, such as protection for critical illness, disability, accidental death, or waiver of contribution;
- retirement annuities (only offered in Malaysia); and
- *waqf* plans – regular savings to accumulate funds established for special purposes (for example to help the needy).

A wide range of investment avenues is now available in the following categories, varying in accordance with local regulations:

- Islamic deposits;
- sukuk / government Islamic securities;
- other investment instruments issued by the Government and private sector;
- equities within *Shari'a* parameters; and
- real estate, commodity, currency and lease-based instruments with fixed returns.

Who is buying *takaful* products?

A prime purpose of the *takaful* system and its products is to strike the right chord with Muslim customers who may find conventional products unacceptable and buy them reluctantly. The *takaful* system and products may be appealing to them for the following reasons:

- the concepts are in line with cultural and religious values;
- the products are as good as conventional insurance in terms of benefits and pricing;
- the system is ethical in terms of investments, channeling funds to assets and businesses that are good for society and the environment;
- the products are transparent and built on mutual help and a cooperative spirit. *Takaful* focuses on the first principles of insurance (the law of large numbers) and on cooperation

amongst participants jointly helping each other at the time of need. This is also the community spirit at a micro finance level that is built on joint efforts to manage risk in a financial proposition; and
- the system is fair to all parties with mutual surplus sharing. Customers are assured of a return in case of claim (the assured benefit) or payment of profit share even where there is no claim (provided the fund is in surplus).

Given these appealing qualities of the *takaful* proposition, are these not products that may be appealing to every person, irrespective of culture or religion? The answer lies in the experience of *takaful* operators (mostly in Malaysia) where a large portion of people buying *takaful* are non-Muslims (in the range of 60 per cent). The marketing message to *takaful* operators is therefore that *takaful* should appeal to Muslims and non-Muslims alike, each having different expectations, preferences and demands that can be provided by *takaful*.

Who are the stakeholders?

Consumers, *takaful* operators (*takaful* and re-*takaful* companies), regulators, *Shari'a* advisors and shareholders are all stakeholders in a *takaful* business.

- *Consumers:* Consumers look for value-for-money benefits aligned with their values and beliefs. Consumers help to turn perceived demand into real demand. Conceptually, they are joint owners of a *takaful* fund, having donated their individual contributions. They have notional ownership of the underlying funds in respect of their savings contributions.
- *Takaful operators:* They offer knowledge, skill and ability to manage and administer *takaful* in building durable and profitable business with *Shari'a* authenticity and regulatory alignment. In return they must receive competitive reward.
- *Regulators:* Their prime focus is to protect policyholder interests and to ensure market confidence through prudential regulations. Some countries have specific *takaful* regulations, such as Malaysia, Bahrain, Pakistan, Saudi Arabia and Sudan. Others try to accommodate the specific nature of *takaful* business within the established and elaborate framework of existing insurance regulations. Examples are Indonesia, Brunei, Sri Lanka and Bangladesh. The support of the regulator for *takaful* business is essential in ensuring the necessary confidence to the consumer.
- *Shari'a advisors: Shari'a* advisors have the largest moral responsibility to ensure that products and operations are true to the letter and spirit of *Shari'a* principles, and to ensure that the expectations of consumers, shareholders and regulatory compliance are managed within the confines of these principles. *Shari'a* approval of a product is not a *carte blanche* for acceptability of the proposition. Continuity of compliance in the management of these operations is essential in providers living up to these expectations.
- *Investors / shareholders:* Like any business, investors expect a reasonable return on their investment, but do have an obligation to consumers to ensure that *takaful* operations are established, promoted and managed strictly in compliance with *Shari'a* principles.

Opportunities for new entrants

There is enormous latent potential in *takaful*. The challenge is how to unlock this potential through a practical approach built on increasing the awareness of underlying concepts, maintaining the highest service standards, and delivering a competitive proposition. When it comes to measuring the potential, there are many factors to take into account, relating to the economics and demographics affecting people's willingness to buy insurance, especially life insurance. These include:

- income levels and the distribution of wealth;
- the propensity to save, the inflationary outlook and tax incentives;
- population, employment, the generosity of state social security systems and the quality of life; and
- cultural and religious bias towards financial risks related to assets and people.

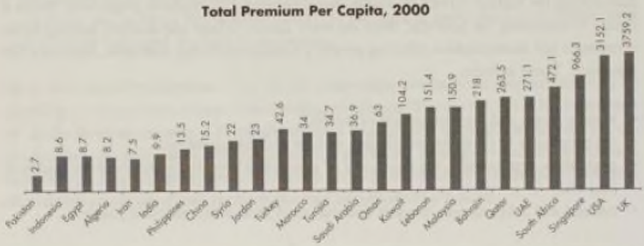
Data such as a country's gross domestic product (GDP) and insurance per capita are pointers to the potential in a market. For example, just 0.5 per cent penetration of life insurance into the GDP of Saudi Arabia would generate US$1.3bn of premiums. This takes Saudi Arabia from US$2 to US$56 of life premium per person, still lower than the United Arab Emirates, no way near the levels in Malaysia, but a considerable jump for Saudi Arabia (27 times the current size). Is this within the realm of possibilities? Possibly, yes. Some estimates for the Saudi market by NCCI and local media provide double the potential just highlighted.

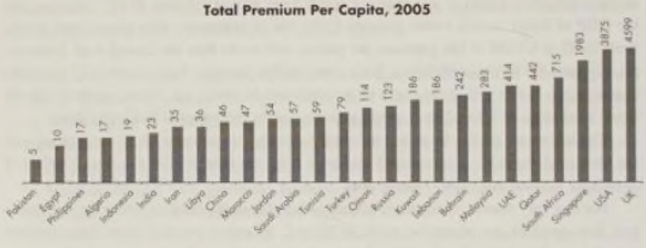
The low spend on life insurance in Saudi Arabia is true for most Muslim countries with the obvious deduction – conventional insurance does not relate to the values and beliefs of customers in these countries. *Takaful* does.

For that very reason, insurance is underdeveloped in many markets where the economics and demographics are otherwise good. In general, insurance penetration in these markets ranges from less than 0.5 per cent to 5 per cent compared to 10 per cent to 15 per cent in markets developed in insurance. This represents a tremendous room to grow, and this is why there is considerable activity in the *takaful* industry in the Middle East: in Malaysia, Indonesia, Sri Lanka, Bangladesh, Pakistan and in many other parts of Asia and Africa. Estimates of the *takaful* business were around US$2bn in 2003 including Iran, of which around 60 per cent is general *takaful*. Estimates are for the industry to grow to between US$12 bn to US$14 bn by 2015. Most of this untapped potential lies in the long-term *takaful* business, such as family *takaful* and related protection benefits, savings products, and retirement benefits. To achieve reach to customers with these products, one needs to build efficient distribution and delivery channels. This is much harder of course than developing products and systems – it can be a costly affair and not easy to establish or manage.

Exhibits 1.15 to 1.18 illustrate that insurance penetration in Muslim countries is generally very low but fast changing. Exhibit 1.15 illustrates that in the year 2000, the majority of Muslim countries had total premium per capita below US$50, and only a tiny number were above US$200: Bahrain, Qatar and the United Arab Emirates.

Exhibit 1.15
Total Premium Per Capita: 2000, 2005 (US$)





Source: Author's own, Sigma Swiss Re

In 2005, many more Muslim countries have moved above the US$50 and US$200 marks. Even countries with very low penetration like Pakistan have doubled the insurance penetration rate.

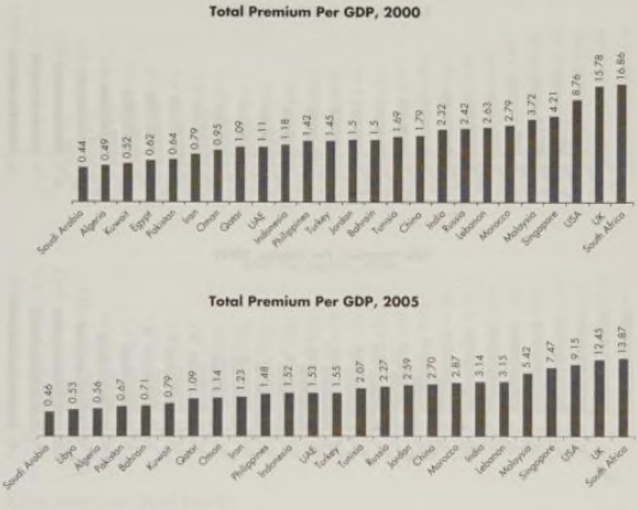
When measured against the GDP, most Muslim countries in 2000 fell below 2 per cent of insurance premium as percentage of GDP, as illustrated in Exhibit 1.16. Only Malaysia exceeded well beyond to 3.72 per cent.

As Exhibit 1.16 illustrates, by 2005 insurance density in most Muslim countries had improved, with more countries crossing the 2 per cent level. Malaysia improved by 46 per cent from 3.72 per cent to 5.42 per cent.

In terms of life insurance, the picture was even more dramatic, as Exhibit 1.17 illustrates. In 2000, most Muslim countries fell below US$50 of life insurance per capita; only Malaysia and Bahrain exceeded this at US$86.4 and US$59.0 respectively. In 2005, there was marked

Exhibit 1.16

Total Premium Per GDP: 2000, 2005 (%)



Source: Author's own, Sigma Swiss Re

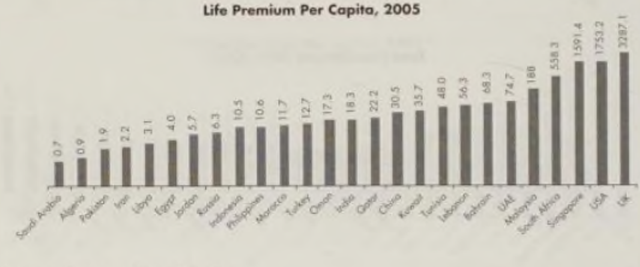
improvement in these countries, with the United Arab Emirates and Malaysia showing impressive growth, from US$37.0 to US$74.7, and from US$86.4 to US$188.0 respectively.

Provided there is an awareness for this need to insure, *takaful* has better potential to grow in Muslim countries even at modest levels of GDP per capita. Let us take Malaysia as an example. Malaysia had a GDP per capita of US$4,762 in 2005. It has succeeded in developing a *takaful* market of sizeable proportions, with premium per capita of US$283 (life premium, US$188), and premium at 5.42 per cent of GDP (life, 3.6 per cent). This example demonstrates that there are a considerable number of Muslim countries with GDP per capita exceeding US$4,000 which have the potential to do the same, if not better.

Some of the Muslim countries are amongst the richest in the world, albeit at population levels that are small, except for Saudi Arabia, Libya and Syria that have larger population bases. Even countries with GDP per capita lower than US$4,000 have good potential in *takaful*. There are several other countries that have not featured in these graphs where potential

Exhibit 1.17

Life Premium Per Capita: 2000, 2005 (US$)



Source: Author's own, Sigma Swiss Re

for *takaful* exists. These countries are spread throughout Europe, Africa, South America and Asia.

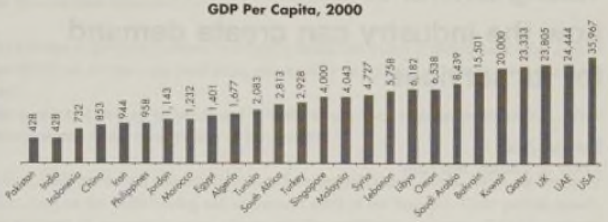
Conclusion

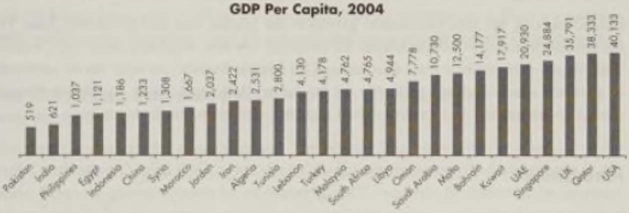
There are ample opportunities for developing the *takaful* industry worldwide. However, only genuine efforts to develop a business in keeping with *Shari'a* principles will bring success. Any attempt to enter the market for the sake of soaking up business without genuine effort to provide a fair system will be of limited value.

Takaful offers opportunities to expand the size of the global insurance market by addressing the needs of consumers with a preference for this type of product. In the marketplace, the attraction of this business is not only the fact that it is based on Islamic law, but because it is a fair system. This aspect should be attractive to everyone, irrespective of *takaful*'s initial religious basis. The correct description of *takaful* is perhaps 'ethical protection', upholding

Exhibit 1.18

GDP Per Capita 2000, 2004 (US$)





Source: Author's own, Sigma Swiss Re

ethical values for society and the environment. These are enshrined in the Islamic financial system of ethical investments and in the use of money to create wealth on the basis of risk and reward, rather than to create more money without commensurate economic risk.

The largest missing resource in the development of *takaful* is not capital but technical resource. For new and existing *takaful* companies to operate on highly professional standards of service and management, and at the same time to have a genuine appreciation of the value of the *takaful* system vis-à-vis conventional insurance is a challenge in itself. The industry has the potential of managing up to US$30 bn of funds by 2015 but do we have the right resources to manage these in building to 2015? Herein lies the true challenge facing the *takaful* industry.

1 Any reproduction of the information contained in graphs in this chapter requires the prior permission of the author, SwissRe Sigma and the Arab Insurance Group, and reproduction must indicate the source reference.

2 Takaful - Global Overview and Opportunities Ahead, Ajmal Bhatty. Available from ajmalbhatty@hotmail.co.uk

Chapter 2

Taking *takaful* to the next level: how the industry can create demand for its services

Sameer Abdi
Ernst & Young, Bahrain

Islamic banking has seen exponential growth in the Middle East and South-east Asia. Yet the Islamic insurance or *takaful* market has remained low-key, especially in the GCC region. This chapter explores how grass-root demand for Islamic financial services can be harnessed to grow the *takaful* industry profitably for the future. Building a strong foundation through market awareness and an incentive-driven regulatory infrastructure is an answer.

Introduction

The concept of *takaful*

The term *takaful* is commonly used to refer to a *Shari'a* compliant form of insurance or assurance contract. *Takaful*, however, is an age-old concept of mutual protection and financial assistance (*ta'awuni* or cooperative) based upon principles set out in the Quran and the Hadith (the teachings of Prophet Mohammed PBOH).

There are certain preconditions which must be satisfied in order for a *takaful* contract to exist:

- *ne'ah* or the sincere intention to follow the principles and rules set out in the *takaful* agreement, knowingly and wilfully;
- integration of *Shari'a* conditions, namely risk protection sharing under the *ta'awuni* principle, coincidence of ownership, the participation in management by policyholders, avoidance of riba (usury) and prohibited investments, and inclusion of *al mudaraba* (profit sharing) or *wakala* (agency) principles for *takaful* management;
- the presence of moral values and ethics, that is, all transactions are carried out honestly and with full disclosure and transparency to all transacting parties; and
- no unlawful element under the *Shari'a* is present, that is, there are no factors present which are expressly prohibited by the *Shari'a*.

Takaful – Is it mutual cooperative insurance?

The concept of *takaful* is often compared to the conventional model of mutual cooperative insurance. At a cursory glance, this comparison is a reasonable one, especially when looking at the two common elements:

- the concept of the policyholders contributing funds into a pool to protect each other against specified risk events – the pool being managed by an operator or management company; and
- the concept of sharing technical and investment surpluses with the policyholders, rather than accruing to the shareholders of the operator.

However, there are certain distinct differences between the Islamic and conventional insurance models, both on the underwriting and investment sides of the business. These pertain mainly to the concept of uncertainty or *al gharar* and the prohibition on usury. *Takaful* contracts must have a pre-determined payout in case of a loss, determined by the contributions of the policyholders. Also, policyholders' contributions must be invested on a *Shari'a* compliant basis, which means that most, if not all, conventional assets are not deemed to be acceptable.

The Middle East insurance market – Is it an opportunity for new entrants?

The simple answer to this question is yes. The Middle East, especially the countries of the Gulf Cooperation Council (GCC), has one of the lowest insurance penetration[1] rates in the world. Given the economic boom for oil-producing GCC countries, the future for the insurance market looks quite promising. A comparison of the GCC markets with other second and first world countries reveals a fascinating story for the future, as illustrated in Exhibit 2.1.

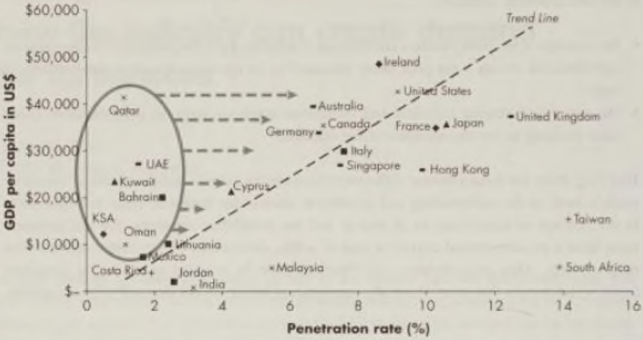
Most GCC countries in Exhibit 2.1 fall short of the median penetration rates of other countries with comparable economic metrics, such as GDP per capita. This illustrates the room for the insurance markets in the region to grow from current levels to almost three times as much in the next few decades.

However, a closer analysis of insurance penetration in the sample of countries reveals more interesting attributes of this marketplace. Unlike other countries in the sample, GCC countries exhibit an extremely low penetration of life[2] versus non-life business, as illustrated in Exhibit 2.2.

Since 2001, there has been a steady increase in the number of *takaful* players across the GCC. However, their numbers are dwarfed by the number of conventional providers. What is interesting is that even though there are many conventional providers, the penetration rates in the region are low, possibly suggesting that the majority of the population is unwilling to buy non-Islamic products and/or conventional insurance providers are unable to target these market segments. This would suggest that *takaful* providers could rapidly increase market share by targeting specific market segments with relevant *Shari'a* compliant products. Logically, an increase in the number of providers will result in better product offerings to customers and force existing players to improve.

Exhibit 2.1

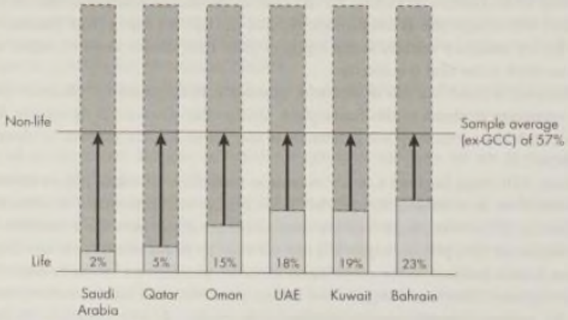
Insurance penetration in the GCC (2005)



Source: Swiss Re Sigma No. 5/2006 Report and Author's Analysis

Exhibit 2.2

Life versus non-life penetration in the GCC countries (2005)



Source: Swiss Re Sigma No. 5/2006

Exhibit 2.3

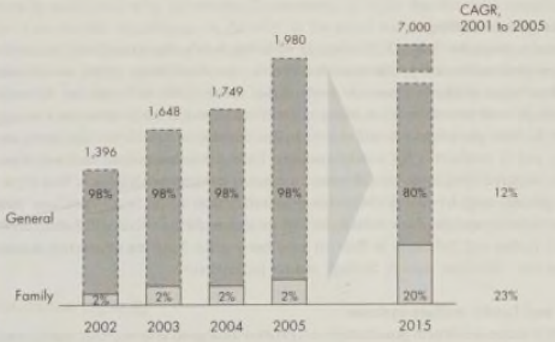
Takaful and conventional insurance companies in the GCC

Country	Number of *takaful* companies in the GCC*	Period of inception pre-1995	Period of inception 1996-2000	Period of inception 2001-2005	*Number of conventional insurance companies***
Bahrain	8	5	1	2	*13*
Kuwait	4	0	2	2	*8*
Oman	0	0	0	0	*10*
Saudi Arabia	6	3	0	3	*22*
Qatar	2	1	0	1	*5*
UAE	3	0	0	3	*220*
Total	**23**	**9**	**3**	**11**	***278***

Source: *ARIG 2006 report **zawya as at 24.7.06

Exhibit 2.4

Future expectations for the *takaful* industry



Source: 2006 *ARIG AIM Report*

Exhibit 2.3 shows the development of *takaful* in the GCC. The majority of *takaful* companies in the GCC are local providers and the market has not seen a mass influx of multinational insurance companies entering the market through an Islamic-compliant window, as has been noted in Islamic banking and wealth management. Such a move should benefit the industry, as these companies possess strong technical and financial capabilities, which can be leveraged to further increase the penetration of the *takaful* target market. Exhibit 2.4 shows the future expected growth in the industry, based on estimates at the time of writing.

Factors limiting the growth

Demographics – Lack of education or awareness?

Islamic finance is by its very nature a faith-based financial system and therefore the demand for *Shari'a* compliant financial products is driven by the retail (individual) customer. This is a phenomenon seen in Islamic banking, where a sizeable portion of the market chooses Islamic financial products over conventional ones, even where the former provides lower economic returns. Therefore, understanding the demographic characteristics of the Muslim populations versus non-Muslim countries is important in making any reasonable conclusions as to why *takaful* (and insurance, in general) penetration is so low in Muslim countries.

Education levels

The level of education in the GCC has been historically low, with many countries actively promoting higher education programmes for their nationals. This is likely to improve consumer understanding of insurance amongst the population segment which is most likely to buy *Shari'a* compliant products. Increasing the number of nationals in private sector employment will also help stimulate demand, at both the corporate and retail levels.

Product understanding

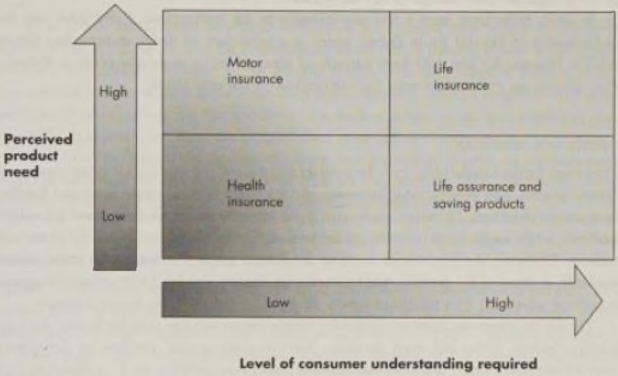
The common consumer in the GCC is largely unwilling to buy non-compulsory[3] conventional insurance products as such products are not *Shari'a* compliant. Many people are unaware of the various types of Islamic insurance products that are available in the market. Information about *takaful* and insurance is not being communicated to the marketplace in a consistent manner. In fact, any researcher will conclude that credible independent information on the industry and its products is not widely available. Exhibit 2.5 summarises the level of understanding required for a common consumer in relation to insurance products. It is clear that *takaful* players need to educate their consumer rather than try to 'push' products through regular marketing and distribution channels. Players such as Al Jazira Bank (Takaful Ta'awuni) in Saudi Arabia and Solidarity in Bahrain have been at the forefront of creating awareness amongst their consumer market, through various programmes.

Social and family welfare systems

Most GCC states are able to provide their nationals with a good level of basic public welfare. Hence, nationals have a high degree of dependence on state benefits. In most cases, nationals have more than one source of income; many will have investments and businesses which

Exhibit 2.5

Consumer education



Source: Author's own

supplement their main source of income. Also, nationals rely on the state or their joint-family systems to assist them after retirement. Consequently, it is felt that the main competitor for many of the *takaful* life offerings in the GCC is the social welfare system already in place.

However, the demographic break-up of GCC countries is rapidly changing. Most of the populations are young and will become a strain on the state and social welfare systems within the next few decades. Therefore, private insurance will become even more important if these population segments are to sustain their lifestyle needs on retirement in the next 30 years. This segment presents an extremely attractive opportunity for *takaful* players, which are willing to invest time and funds in educating their target markets.

In the case of expatriates, employers in most cases will provide varying degrees of benefits to them and in all cases access to state pension is restricted. Many expatriates will either repatriate their funds to their home countries or into offshore savings plans or set up savings accounts in the host country.

Reinsurance capacity

Re-*takaful* is a vital part of the *takaful* industry, as reinsurance is to the insurance industry. The key benefits of re-*takaful* are the transfer of risk, capital relief provision and improved product development. In 2005, there were four re-*takaful* companies in the world with a total

...er capital of US$235m. Only Best Re, a Tunisian-based company, had an international rating from Standard and Poor's (S&P) of BBB-, which is below investment grade. Traditionally, reinsurance companies have an investment-grade rating at a minimum and the top six companies have ratings of AA- or higher.

In 2006, there have been a few new entrants to the marketplace. Early 2006 saw the establishment of Takaful Re in Dubai, which is a subsidiary of the Arab Insurance Group (ARIG). Hanover Re and AIG have announced plans to set up re-*takaful* pools in Bahrain. More players are expected to enter the marketplace in the near future.

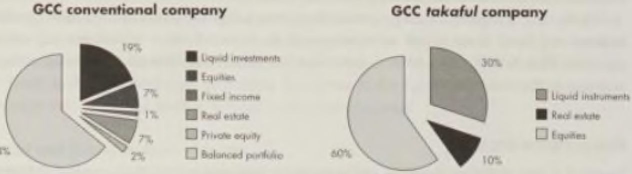
Investment allocation

A key issue for the *takaful* industry is the availability of *Shari'a* compliant investment avenues. *Takaful* players, like conventional insurance players, need to have astute asset and liability management processes. Therefore, short-term liquid investments are needed to meet immediate liabilities, while longer-term investments are needed for the life or family *takaful* (long-tail) business. However, the investment universe for *takaful* players is limited by conventional standards, in terms of the diversity and tenor of asset classes. Exhibit 2.6 illustrates the typical investment allocation by a *takaful* company versus a typical GCC insurance company.

The key to improving asset allocation for *takaful* companies lies with the Islamic banking industry. Islamic banks and asset managers need to place special attention on developing *Shari'a* compliant treasury and asset management products to complete the asset class spectrum for *takaful* companies. The *sukuk* market is one such example. *Sukuk*, both short- and long-dated, are essential investment instruments for *takaful* companies, especially those with long-tail family *takaful* portfolios. Although there has been an exponential increase in the number and volume of *sukuk* issues, considerably more work needs to be done to deepen both the primary and secondary debt capital markets. In addition to the fixed income markets, *takaful* companies also need to be able to invest in *Shari'a* compliant alternative investments, namely private equity and hedge funds.

Exhibit 2.6

Comparison of asset allocation – GCC conventional versus *takaful*



Source: Author's own

Human resources

Training and developing staff is fundamental for the long-term prosperity of the industry. Investment in people is needed on two levels, at the commercial level and at the *Shari'a* level.

Most senior management in *takaful* companies have gained their formal underwriting qualifications and experience in the conventional sector before moving across to the Islamic insurance sector. Going forward, a dual training system is needed, whereby training in both conventional insurance and *takaful* is obtained simultaneously, through programs such as the ACII qualifications. Fledgling attempts have been made at achieving the dual training system, especially in Bahrain, but more needs to be done at an industry-wide level.

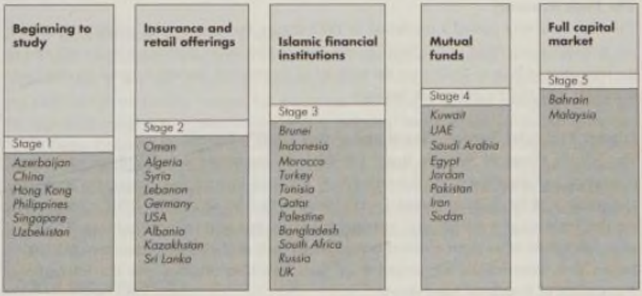
In addition to training and developing people in underwriting *takaful*, the industry needs to recruit and retain the best people in other areas such as marketing and distribution, claims handling, finance and operations (including information technology).

Regulatory enablers

Exhibit 2.7 illustrates that countries in the GCC are at different stages of developing their Islamic financial services industries. Bahrain has been able to develop a fully fledged capital market partly through initiatives of the Central Bank of Bahrain (CBB – formerly the Bahrain Monetary Agency) and enabling institutions such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

Exhibit 2.7

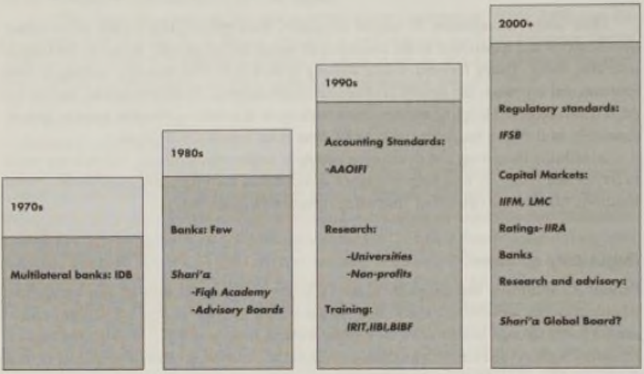
The development of the Islamic financial services industry



Source: Dawney Day Global Investment Limited

Exhibit 2.8

Infrastructural developments in the industry



Source: Dawney Day Global Investment Limited

The key infrastructural developments that have taken place over the past 30 years are summarised in Exhibit 2.8.

The Fiqh Academy

The Fiqh Academy passed a resolution in 1985 stating that commercial insurance contracts are prohibited according to the *Shari'a*, and that an alternative contract which conforms to the principles of Islamic dealings is the contract of cooperative insurance, based on charitable donations and *Shari'a* compliant dealings.

Islamic Financial Services Board and global Shari'a board

The Islamic Financial Services Board (IFSB) is an international standard-setting body of regulatory and supervisory agencies that have a vested interest in ensuring the soundness and stability of the Islamic financial services industry. The aim of the IFSB is to promote the development of a prudent and transparent Islamic financial services industry. The IFSB works alongside other super-national organisations such as the Basel Committee on Banking Supervision, International Organization of Securities Commissions and the International Association of Insurance Supervisors.

At the time of writing, there is no global *Shari'a* board to regulate *takaful*; however, the AAOIFI, Dubai International Financial Centre (DIFC) and the CBB all have their respective

Shari'a boards. Some *Shari'a* scholars sit on more than one regulatory board and in some cases they will also sit on corporate *Shari'a* supervisory committees. Discussions are underway for the development of a global *Shari'a* board, which would be part of the IFSB. The main obstacles to the creation and operation of this board are reconciling the different Islamic views that underlie Islamic finance, and the legislative powers of the super-national board.

Accounting and Auditing Organisation for Islamic Financial Institutions

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) is the main accounting standards board in the Islamic finance arena and is responsible for developing new standards and encouraging the application of these standards. AAOIFI standards are used in 27 countries and AAOIFI has 115 members, which include the Dubai Financial Services Authority (DFSA) and a number of leading Islamic banks and Islamic insurance companies. The organisation has written two standards – FAS 12 and 19 – that are applicable to *takaful* and re-*takaful*.

Central Bank of Bahrain

The Central Bank of Bahrain (CBB) is considered the most progressive in the region. The CBB has specific rules for *takaful* (including re-*takaful*) in an Insurance Rulebook. The aim of the rules is to provide the same level of protection to consumers as conventional insurance offers, and to ensure stability in the market. The key aspects of the rules state that companies can operate either as *takaful* or conventional insurance providers, but not both. The prescribed models to be used are the *al wakala* model for all underwriting activities and the *al mudaraba* model for investment management. The rules permit offshoring activities, if operations are headquartered in Bahrain. The CBB rules cover corporate governance, statutory audits, capital adequacy, conducting business, risk management (compliance with Basel II, where applicable), anti-money laundering and reporting.

Many *takaful* operators are registered in Bahrain but carry out business in other GCC countries such as Saudi Arabia and Qatar, which is indicative of the progress that the CBB has achieved.

Dubai International Financial Centre

The Dubai International Financial Centre (DIFC) has ambitious plans to become a world financial hub. It is a self governing financial district, which has been designed to offer 100 per cent foreign ownership, various tax incentives, including double tax treaties and zero tax for registered companies. Financial institutions, including insurance companies, are governed by the Dubai Financial Services Authority (DFSA), which has based its operating and regulatory model on the leading financial regulators globally. In the case of Islamic finance, the regulations are similar to those promulgated by the CBB. The DIFC has made advances in attracting both conventional and Islamic insurance players to Dubai. Takaful Re is one such company, which has established itself in the DIFC, although its parent company ARIG is based in Bahrain.

Shari'a convergence

Until recently, there was uncertainty on the type of underwriting model to use: *al mudaraba* or *al wakala*. Steps are now being taken by regulators and enabling agencies to promote the

use of a single model within the region. The *mudaraba* model has been accepted by Bank Negara Malaysia as an acceptable model to be used in Malaysia. However, most GCC scholars have disagreed with this model and believe that the *wakala* model for underwriting is more compliant. The CBB and AAOIFI promote the use of the *wakala* model.

In addition, many of the regional *Shari'a* scholars that provide advice to Islamic insurance companies are advising more than one institution. The benefit of *Shari'a* scholars acting on multiple boards is the improving consensus amongst *takaful* companies on various *Shari'a* compliance issues.

Exhibit 2.9

Summary of *Shari'a* scholars

Number of *Shari'a* scholars	Number of *takaful* boards	Number of states covered
23	1	1
1	2	1
1	3	2
1	4	2
1	5	3

Source: ARIG 2006 report

From Exhibit 2.9, it can be seen that there are some scholars that provide cross-border *Shari'a* advice to *takaful* companies, thus increasing regional consensus. Furthermore, customers both at the retail and the corporate levels are judging *takaful* providers based on the quality and reputation of their *Shari'a* scholars. There is a growing tendency for new entrants to secure the advice of a well-established *Shari'a* scholar.

What needs to be done for the future?

The future of the *takaful* industry is entirely dependent on industry players, which must take a more active role in educating their customers and regulators, while enhancing discipline in their activities. Exhibit 2.10 summarises the areas where *takaful* players need to focus their efforts, in order to be commercially successful in this fledgling marketplace.

By concentrating on the factors outlined in Exhibit 2.10, *takaful* players can ensure that the growth and profit potential of this industry is harnessed and that it experiences the same phenomenal growth patterns as the Islamic banking industry has through the last decade.

Exhibit 2.10

Field of vision for *takaful* players

Source: Author's own

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1 Insurance penetration is commonly defined as gross insurance premiums written in a country, divided by the GDP of that country and expressed as a percentage.

2 Life business for the purpose of this analysis does not include accident and general health which have been included as part of non-life.

3 Compulsory forms of insurance include motor and, in some countries, medical and health insurance.

Part II

The *takaful* models and mechanisms

Chapter 3

Family *takaful* as a driver of wealth management enterprise

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Introduction

As the Islamic-world prosperity continues its striking expansion, wealth management will likely increase its relevance as a discipline for addressing the financial needs of affluent and middle class Muslims from Istanbul to Jakarta. Wealth management does not have a standard definition. Rather, it spans a broad range of services from estate planning through private banking to financial planning. We use it here to refer to a customer-oriented approach to investment product design and service – one that takes a 360-degree perspective on family financial assets, regardless of the customer's wealth level.

With its foundation on *Shari'a* principles and the keystone of collective investment, the *takaful* business has the capability to capture a significant share of the Islamic wealth management enterprise. After all, family *takaful* is more than a mere mechanism for wealth management – one can argue that, with its emphasis on savings programmes, wealth management is uniquely the *purpose* of family *takaful*.

This objective appears greater for family *takaful* than for conventional life insurance, which faces considerable competition for this role, within the broader financial services industry as well as among insurers. While bifurcation of the Islamic wealth management business between banking and insurance may evolve similarly to how it has in the conventional arena, we see *takaful* operators taking a particularly prominent role in this discipline.

Compelling demographic opportunities

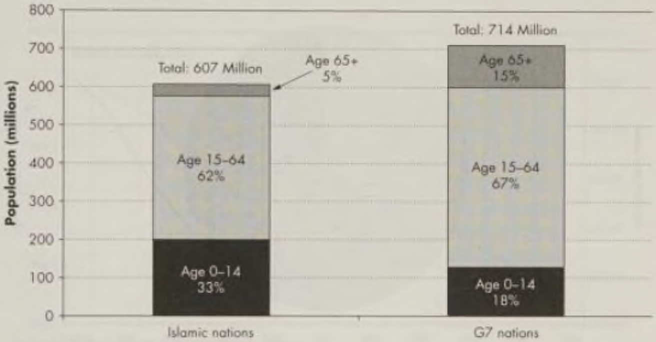
Demography uniquely favours the *takaful* companies in the evolution toward an expert wealth management business. The Islamic economy holds potential for spectacular growth. As the middle class flourishes across the Islamic world, both income growth rates and the relative youth of the population provide a highly attractive market. IMF and World Bank data confirm the rapid increase in both the potential demand and the capacity to buy family *takaful* products (see Exhibits 3.1 and 3.2).

Once a *takaful* provider taps into this market with effective marketing and sales strategies, the potential for profitability is enormous, albeit undefined. The size of this audience and the

Exhibit 3.1

The Islamic demographic skews young

The relative youth of the Islamic world provides a healthy supply of potential *takaful* buyers for years to come.



2004 Population of Islamic and G7 nations

Data as of 31 September 2006. Islamic nations include Bahrain, Egypt, Indonesia, Jordan, Kuwait, Lebanon, Malaysia, Morocco, Oman, Pakistan, Qatar, Turkey and the United Arab Emirates. G7 nations include Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America

Source: World Bank, Calyx Financial

volumes it could produce are among the reasons conventional players have entered the *takaful* business. Citibank, HSBC, and Singapore-based NTUC Income, to name just a few financial entities, are crafting *takaful* franchises. Conventional insurers, in particular, are pursuing this Islamic opportunity on the likely assumption that the phalanx of competitors in mature markets may be overlooking or undervaluing the increasingly affluent Islamic population. Global insurance giant AIG announced in October 2006 a Bahrain-based *takaful* enterprise, perhaps drawing internal lessons from the company's success in retail markets such as the Philippines and Taiwan, decades before it became the largest US-based insurer.

Moreover, the crossover opportunity in the Islamic world works both ways. Family *takaful* products have the potential to compete successfully with conventional life insurance. Broadly speaking, the mutual insurance model offers some familiarity. When one highlights the consumer benefits that characterise family *takaful*-transparency, limits on profit-taking, the alignment of insureds' and operators' interests, ethical investment guidelines – this represents a powerful proposition to Muslims and non-Muslims alike.

Exhibit 3.2

Prosperity is growing aggressively in Islamic nations

Accelerating affluence among Muslims suggests both growing need and capacity to buy savings and security products.

Gross domestic product per capita of G7 and Islamic nations

Data as of 30 September 2006. All data are population-weighted composites in US dollars. Islamic nations: Bahrain, Egypt, Indonesia, Jordan, Kuwait, Lebanon, Malaysia, Morocco, Oman, Pakistan, Qatar, Turkey and the United Arab Emirates; data from 2005 onward are IMF estimates. G7 nations: Canada, France, Germany, Italy, Japan, the United Kingdom and the United States; data for the United Kingdom, from 2004 onward and for the remaining G7 nations, from 2006 onward, are IMF estimates.

Source: International Monetary Fund, Calyx Financial

A few lessons from conventional life insurance

Conventional life insurance provides some interesting pointers for the potential evolution of family *takaful* as a framework for wealth management: both positive and negative lessons.

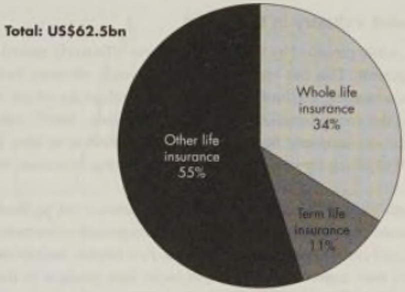
The traditional whole life policy, which offers set premiums, guaranteed coverage, and scant investment income, has progressed over three decades to various products intended to address customer dissatisfaction with low investment yields. Universal life, variable life and other variations on the theme essentially combine life insurance with retirement savings. In effect, these products protect family income from two forms of untimely death: the 'too-early' demise of an income-earner and the 'too-late' death of the retiree whose funds have run out. The history of investment-life products is somewhat bumpy, but the healthy share they represent in the written premiums of US life insurers indicates their prevalence (see Exhibit 3.3).

While a marketing success, conventional investment-life products provide a more negative example of transparency to the customer. Consumer advocates have long decried the

Exhibit 3.3

Non-traditional life products dominate the US market

Life insurance products other than traditional whole and term life, including universal and variable products, account for the majority of new policy value in the United States.



Annual US life insurance net premiums written

Data as of 31 December 2000.

Source: A.M. Best Company, Calyx Financial

complexity of these insurance policies and the murkiness surrounding the breakdown of the insured's premium: how much of it buys life coverage, how much of it provides investment returns, and how much goes to agent fees, insurer overhead, and profits.

Indeed, one critique of investment life insurance is that the consumer can better achieve long-term financial objectives by buying inexpensive term coverage from an insurer, and investing the rest directly. The argument in favour of the 'buy term and invest the difference' strategy is that do-it-yourself invested assets work harder than investment-life premiums from which the insurer deducts expenses and profits. The counter-argument points out that investment professionals employed by insurers have more expertise and time to devote to achieving returns than does the typical layperson.

It should also be noted that wealth management has a particular linkage to income taxation in the United States. To encourage retirement savings, the US tax code allows taxpayers to shield a portion of their earnings each year from current tax obligations by investing them in Individual Retirement Accounts (IRAs) and employer 401(k) plans. This pattern steers the middle class toward banks, brokerages, and mutual fund companies for wealth management services.

The US life insurance industry, on the other hand, benefits from a tax-advantaged status that becomes especially important for high net-worth individuals. High earners typically hit

the limit each year on how much of their pre-tax income they can dedicate to IRAs and 401(k) plans. Investment-life products, however, offer an additional mechanism for deferring income and estate tax obligations on investment income until the holder retires and presumably enters a lower tax bracket.

The Islamic investment industry in transition

US conventional insurers, while propelled by tax legislation, have effectively moved into the domain of wealth management. This has created a complex wealth advisory business in the US across the insurance, banking, and brokerage businesses. Perhaps the *takaful* business may be able to leapfrog the conventional-industry history? Already, family *takaful* has condensed the evolution of life insurance from a simple death benefit to at least a simple investment product, aimed at saving for purposes such as homebuying, education, marriage, and the *Hajj/Umrah*.

The burgeoning growth of *Shari'a* compliant banking and finance has focused largely on offering an array of consumer products, including cash management instruments, home and automobile financing, and convenience banking products. Few Islamic institutions appear to have moved to segment their consumer audience and target their products to the degree that have conventional banks. Dubai Islamic Bank represents one notably mature exception, with an independent private banking unit in separate offices. More typically, the financial planning attitude has not yet arrived at younger institutions still building their basic business of depository and credit products.

Much of this growth has been indiscriminate because of macro factors affecting the Islamic economy, particularly the Middle East. Beside the well-documented oil-price benefit and Islamic consumer preferences for 'cultural demonstration' in product choices, the rapid growth of Islamic finance also relates to the beneficial liquidity impact of abnormally low US interest rates. While a thorough treatment of the global macroeconomy is beyond the scope of this discussion, we believe that expansion of *Shari'a* compliant finance was one of many residual outgrowths of unusually lax US monetary policy. The Federal Reserve's primary concern was keeping the US economy afloat in the wake of the technology bubble implosion and 9/11 (see Exhibit 3.4); its focus clearly was not on the industry it was indirectly creating across the Islamic world. In short, Islamic banks rode the wave of this reflation, benefiting from macro trends. We expect the velocity of further business growth will not be gained with such ease.

The marketing evolution of *takaful*

While there are obvious distinctions between *takaful*, Islamic banking and conventional financial services firms, there are a surprising number of similar issues with which these organisations need to grapple to support their wealth management business. Below are three of the primary issues from our own experience with the US conventional banking and insurance business. We contend that the basic information a financial-services enterprise must understand about its business includes to whom you are selling, what you are selling, and how you are delivering

Exhibit 3.4

US Federal Reserve reflates the global economy

The period of declining interest rates after 2001 benefited Islamic economies as well as the United States.

Federal funds rate (3-month moving average)
Data as of 30 September 2006.

Source: FactSet, Calyx Financial

it. These issues have been addressed with varying degrees of success thus far among Islamic financial institutions.

- *Client base*. Efficiency in financial services marketing requires segmenting clients into discrete categories according to income or interests. Two examples prevalent in the Gulf are UHNW (ultra-high net-worth individuals) and NRI (non-resident Indians).
- *Product offering*. Most investment vehicles inherently address a set of client-specific needs, leaving aside products such as *murabaha* that have universal applicability. Once again, marketing efficiency draws a connection between product attributes and customer segments, rather than trying to be all things to many people.
- *Distribution*. Despite the advent of the internet, financial services remains a classically personal-sales-dependent business in most markets. The *takaful* salesforce, while nascent, will likely become a management priority.

Each of these issues provides an important point of departure from which the *takaful* business can learn and in turn grow its wealth management capabilities.

Exhibit 3.5

The comparative evolution of Islamic finance

	Takaful	Islamic banks	Conventional insurance
Client base	Unsegmented	Unsegmented	Segmented
Product offering	Limited	Expansive	Targeted
Distribution	Sales-driven	Supply-driven	Market-driven

Source: Calyx Financial

The Islamic consumer financial services business, both *takaful* and banking, has been growing very rapidly. In the past, there may have been little point to segmenting its business across demographic groups. That is likely to change as consumer preferences emerge, competition heightens, and branding strategies evolve among institutions.

Important distinctions appear between *takaful* companies and Islamic banks when assessing product offerings even at this relatively early stage (see Exhibit 3.5). On the banking front, Islamic institutions are developing an ever-growing array of instruments for the individual consumer, with an emphasis on credit-equivalent products and depository accounts. Competition, in turn, has grown intense. Management at one Malaysian Islamic bank, for example, has decided to retool the institution as a wholesale provider because of margin pressure on the retail side of the business.

Takaful companies, to date, typically offer a smaller array of financial products, albeit with more of an emphasis on long-term savings. The arrival of a meaningful array of investment funds has only begun at a few institutions, such as Bahrain's Solidarity which offers a range of savings and protection plans, and via the FWU Group's open-architecture 'white label' product lines created for institutional clients. Increasingly popular routes for *takaful*-operator growth intersect with external providers for fund management and banks for product distribution.

Takaful companies may be better suited to prosper through the necessary market-driven strategies and sales-supporting mechanism than other Islamic institutions. To date, the revenue model for most Islamic banks, with a few notable exceptions, appears to be supply-driven. In other words, they have worked on the premise that, 'if we build it, they will come'. The experience of the conventional wealth management industry suggests the most profitable firms will be those that identify the nuances of market segmentation and pricing in relation to volume (that is, mass or 'class'). *Takaful* companies may be able to seize an opening here regarding their chosen investment-product focus.

Takaful investment portfolio construction

Takaful operators may find the most beneficial lessons from the conventional financial services industry in developing a wealth-management approach to serving consumers. Not only do marketing efforts benefit from consumer segmentation, the financial planning discipline does

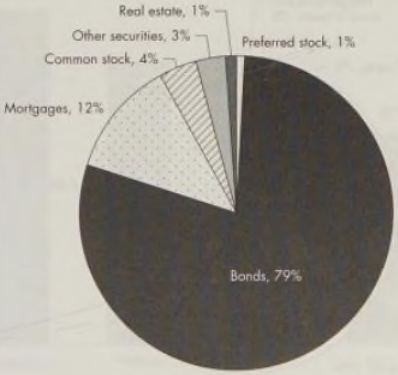
also. The typical wealth-management client relationship at a US brokerage or insurer begins with a customer profiling exercise that leads to an asset-allocation recommendation that falls somewhere on a spectrum from highly personalised to 'mass-customised'.

A key issue now facing Islamic finance is the need to develop the full range of investment vehicles necessary to implement a truly risk-managed portfolio. On a *Shari'a* compliant basis, recent years have seen notable progress in building-out offerings within the global equity asset class. Jeddah-based National Commercial Bank (NCB) has been among the institutions at the forefront of this effort.

Nevertheless, the overall Islamic investment marketplace still takes the form of a barbell, with equities and real estate at either end. There is a need for considerably more development in what we call 'core components': Islamic vehicles that are akin to the role of fixed-income instruments in conventional portfolios, as demonstrated in Exhibit 3.6. These would include *sukuk* instruments, real estate leasing vehicles, and dividend-paying funds. Despite the popularity of underlying *sukuk* issues, for example, scholarly controversies over *sukuk* structures have necessarily limited offerings available in the marketplace. The limited number of *sukuk*

Exhibit 3.6

Conventional insurer portfolios rely on fixed-interest instruments



US life insurance company investible assets

Data as of 31 December 2004. Analysis based on US insurer portfolios with aggregate assets under management of US$310.6bn. Other securities category includes a wide range of investments such as oil and gas production, transportation equipment, mineral rights, fixed or variable income instruments, joint ventures or partnerships, and capital instruments.

Source: Conning Research & Consulting, Calyx Financial

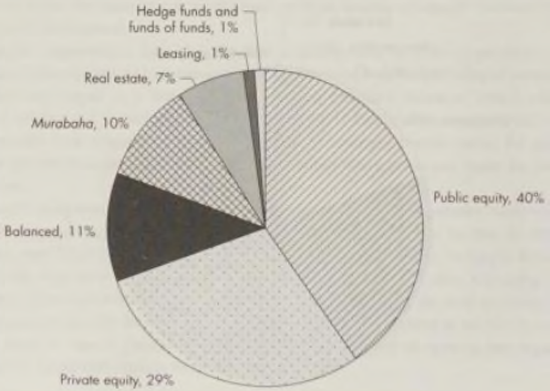
now available tend to be based on real estate; there is considerable need for corporate, infrastructure, and project-related *sukuk* to balance the risk profile of equity vehicles.

As Exhibit 3.6 demonstrates dramatically, US insurers rely heavily on fixed-income investments as core portfolio elements for matching asset and liability streams. In sharp contrast, our sample of *Shari'a* compliant funds in Exhibit 3.7 indicates an over-representation of the equity asset class. Near-term this may not be a pressing issue because the population of the Islamic world skews relatively young. More aggressive portfolios with large equity components may be appropriate for these early savers, given the extended investment horizon at stake. As these aggressive investors mature into conservative ones, however, the industry will need to grow alongside the customers it serves. NCB's AlManarah series is an early entry into the 'lifestyle' portfolio line, offering funds of funds tailored for conservative-, moderate-, and aggressive-growth objectives.

Fiduciary responsibility alone will likely prompt the market to recognise this need for a heightened range of *Shari'a* compliant investment vehicles. *Takaful* operators have to manage risk as appropriately as possible, both tactically and strategically. As investment targets, many

Exhibit 3.7

Islamic fund universe relies heavily on equity vehicles



Analysis of Islamic funds by assets under management

Data as of 30 September 2006. Analysis based on 210 *Shari'a*-compliant funds with total assets under management estimated at US$21.8bn

Source: Calyx Financial

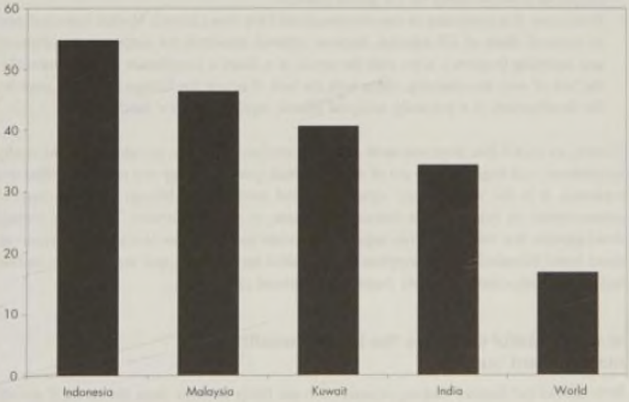
of the individual Islamic markets are limited in their investment scope and can be highly volatile. In response to the growth of client demand, portfolio diversification principles will require reach beyond local markets (see Exhibit 3.8). Perhaps the great irony here is that the Federal Reserve, in indirectly supporting the Islamic banking and finance business, may also have indirectly created a new source of portfolio flows to cover the US current account deficit. This of course is an odd twist of fate, but also reflects the globalised nature of the investment business.

Prudent risk management requires a global manager to manage regional market exposure within the context of relative size of opportunity. Nevertheless, flexibility in adapting traditional models to serve Islamic investors may recognise the appropriateness of a bias toward above-average emerging-market exposure. Islamic investors tend to live in more volatile markets and therefore intuitively understand the dynamic ebb and flow of securities prices. In other words, they are less troubled by Sharpe ratios when analysing investment return data. Other

Exhibit 3.8

General diversification reduces risk

Takaful clients may be best served by investment fund portfolio extending beyond local markets.



10-year standard deviation of equity price returns

Data as of 30 June 2006. Standard deviations are calculated based on year-to-year US dollar price returns for the generally accepted broad market indices: Indonesia Jakarta Composite Index, Malaysia KLSE Composite Index, Kuwait KSE Index, India SENSEX Index, and the MSCI AC World Index. We use Kuwait, for which eight years of data are available, as a proxy for Gulf returns.

Source: FactSet, Calyx Financial

more fundamental reasons include the growing influence of emerging markets on the global stage.

Islamic investors and the US capital markets

No discussion of the need for global diversification would be complete without addressing, at least superficially, the fact that some Islamic investors prefer to avoid the US capital market. That may be a cyclical expression toward US government policies, including heightened 'know your client' directives; it may reflect higher confidence in local opportunities. Certainly, we can respect investor preferences. However, capital controls aside, the idea that Middle East or South-east Asian investors can assemble a well-allocated portfolio while avoiding the US capital market in general, and US equities in particular, is tenuous for several reasons.

- *Size*. Ignoring the world's largest equity market eliminates half of all global investment opportunities. Depending on how you assemble the data, North America represents some 40 to 50 per cent of world market capitalisation.
- *Quality*. We further question the logic of trying to isolate US stocks from a portfolio because relatively few large-capitalisation companies operate strictly within US national borders. From General Electric to Starbucks, these are global organisations whose stocks happen to trade primarily on US public markets.
- *Disclosure*. It is interesting to note that the global Dow Jones Islamic Market Index includes an outsized share of US equities, because national standards for corporate transparency and reporting frequency align with the needs of a *Shari'a* compliance review. Ironically, the lack of such transparency, along with the lack of access for foreign investors, impedes the development of a generally accepted Islamic equity index for Saudi Arabia.

Further, we expect that more and more *Shari'a* compliant offerings, beyond traditional equity investments, will begin to arise out of the US capital market. By any one of several objective measures, it is the world's most dynamic capital market. The Islamic offerings may be enhancements on existing trade finance, real estate, or *sukuk* structures. They may include developments that we cannot even begin to appreciate today. We are less sanguine, however, about broad Islamic-investor acceptance of so-called hedge funds, and suggest their success will reside with a more narrowly focused institutional client base.

In sum: *takaful* can drive the Islamic wealth management business

Both *takaful* and Islamic banking organisations are likely to suffer from the strain of growth unless they undertake further segmentation of their marketplace. There is a clear need to distinguish among consumer, personal, and private banking markets; otherwise these organisations run the risk of confusing, and therefore losing, their audiences.

While Islamic banks, and even more so, conventional banks, are offering an expansive product line, there is a lack of positioning within that product line. Especially in the Middle East, Islamic banks seem to have stumbled in adopting a market-driven approach to product

creation and distribution. The lack of urgency is temporary, we believe, resulting from demand created by the liquidity effect of a strong oil price and reflationary US monetary policies, as well as the 'cultural demonstration' inspired by shifting geopolitics.

As the Islamic investment field matures, flourishing competition and consumer demand will inevitably stimulate a more discriminating market environment (as well as more exacting regulatory oversight). Institutions will be expected to offer their clients a spectrum of risk-managed investment products that provide asset allocation, informed by diversification and global access. This suggests that the *takaful* business can readily challenge both conventional and Islamic competitors and secure a healthy share of wealth-management activity. It can gain this advantage by designing such products with a marketing perspective and providing them through a service-oriented distribution network.

Chapter 4

Takaful: a question of surplus

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Introduction

A question often asked is, 'How does *takaful* differ from conventional insurance?' The oft-quoted answers are that insurance has elements of *riba* (interest) and *maysir* (gambling) and that the insurance contract itself has the element of *gharar* (sale of risk, uncertainty).

Such arguments may satisfy some but others may go away still unconvinced of the arguments proffered against conventional insurance for those of the Islamic faith. They have seen Islamic loans which are interest-free but not profit-free and wonder whether *takaful* offers a similar case of re-labeling. The point often missed by those questioning the basis of Islamic finance is that Islamic structures are asset based and fixed price, whereas most interest-based financing is not.

Takaful has gone through a rapid phase of growth since 2003. This rapid growth is very apparent given that we have seen considerably more interest in *takaful* since 2003 than in all the years preceding that. *Takaful* and re-*takaful* are attracting interest from all quarters.

As with any new industry, the question of standards becomes an issue. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in October 2006 issued an initial standard on the *Shari'a* aspects of *takaful* which is commendable, yet the standard is not binding on all *takaful* companies.

This article looks at one very important aspect of *takaful* and raises some questions for the practitioner to ponder and discuss. That aspect is the question of surplus in *takaful*.

The mudaraba model

The mudaraba model for *takaful* is rapidly losing ground as the *takaful* model of choice. In Malaysia, of the nine *takaful* operators at the time of writing, only two practice the mudaraba model: these were also the first two *takaful* operators to be established in Malaysia.

The mudaraba *takaful* model works on the following basis: the *takaful* operators (shareholders) incur all the expenses of running the business and in return are entitled to a share of the underwriting excess and investment profit. This is an adaptation of the Islamic commercial contract of mudaraba between the entrepreneur (in this case the *takaful* operator) and the capital provider (the participants or policyholders). The biggest objection to this model is that underwriting excess is not profit. It is the excess of premiums over claims. Technically, this is called surplus. As a business model, this is a difficult model to manage, as expenses

are fixed (known) but income (surplus) is not (and can be volatile). From the participant's perspective however, this is a very good model, as he does not contribute directly to the operator's costs. Effectively, all his contributions (that is, premium) are available to meet claims. Only when there is any excess of contribution over claims will the operator be compensated for expenses incurred, and even then only to the extent that its share of the surplus is sufficient to meet these expenses.

Contributions into the *takaful* risk pool are deemed as donations (under the Islamic contract of *tabarru'*) towards claims that are expected to arise. The adoption of the *tabarru'* and the mutual nature of the risk-sharing in this risk pool address the fundamental concerns of the *Shari'a* about conventional insurance. At the end of the contract term the *tabarru'* will not exactly equal the claims. Where the *tabarru'* is insufficient, there will be a deficit; where it is too much, there will be a surplus.

Surplus under the mudaraba model is crucial for the company to be commercially viable. Take away the surplus sharing and the whole model collapses.

The *wakala* model

The *wakala* (agency) model is the default standard for *takaful*. The reason is easy to explain. The operator charges a fee (the *wakala* fee) and runs the *takaful* operation. To the *takaful* operator, he makes a profit should his *wakala* fee exceed his expenses. It is now a question of achieving critical size as soon as possible to eliminate any expense overruns, a familiar target for those in the insurance industry. Now, what about the surplus?

The argument for and against surplus sharing

First, to whom does the surplus in the risk pool belong? The term 'surplus' in *takaful* actually only applies to 'excess contribution' (that is, premium) over claims in the risk pool. This is different from 'surplus' in conventional insurance. 'Surplus' in conventional terminology can refer to surplus arising from the total of:

- excess/deficit of premium expense loading over expense incurred;
- excess/deficit of investment income realised over expected income; and
- favourable/unfavourable mortality/morbidity experience over expected.

To reiterate, because expenses are wholly met from the shareholders' fund and investment income is normally accounted separately from claims, surplus in *takaful* actually only refers to the excess of premium received over claims.

Under both the mudaraba and the *wakala* models there will be instances when premiums can exceed or are insufficient to meet claims. This arises as insurance is one industry where you pay for your service before the service is delivered. If it were possible to pay your premiums at the end of the policy term then surplus or deficits need not arise.

It is interesting to observe that under *takaful*, premiums are donated to the risk pool. What this means is that the premiums paid to the *takaful* risk pool cease to belong to the participant and are available to meet claims. This concept of risk-sharing among a group of

individuals can be traced back to the origins of conventional insurance: they are now called 'mutuals' or cooperative insurance companies.

Once it is appreciated that the 'surplus' is actually excess premiums paid by the participants, then the surplus refund is better described as an experience refund. Once this is accepted, then it is clear that the surplus belongs to the participants.

To some *Shari'a* scholars, however, given that the premium has been donated, there is no question of giving an experience refund. Some suggest that it is more appropriate to give this surplus away to charity instead. To get around this issue, the *tabarru'* has been called a conditional *tabarru'*, with any excess or deficit to be addressed by the participants as it arises.

In Malaysia, some *takaful* companies provide for the shareholders to share in this experience refund. Given that the participants are responsible for deficits in the risk pool, it may seem odd that the participants have to share any excess contribution with shareholders. Many see this as incentive compensation to the operator for managing the portfolio well, as evidenced by the existence of surplus. It is a moot point, however, whether this incentive is necessary given that the operator is already receiving a fee for the underwriting service. At one end of the range of *wakala* models, as practised in Malaysia, is the model where the operator only charges his management and distribution costs through the *wakala* fee, while his profit comes from the sharing of any underwriting surplus. To take this even further, there is a *wakala* model where even the management expenses and distribution costs are met from underwriting surplus and zero fees are charged. This last extreme *wakala* model, as the reader would notice, is identical to the mudaraba model. Indeed some *Shari'a* scholars would even describe the mudaraba model as a *wakala* model with zero fees.

The participant's perspective

From the participant's perspective, the decision as to using a *wakala* model where the operator shares in the excess premium or not will depend on how much higher are the *wakala* fees he has to pay.

The following is an example:

Model A

A *wakala* fee of 30 per cent of the contribution / *tabarru'* and the operator takes 50 per cent of any underwriting surplus arising.

Model B

A *wakala* fee of 50 per cent of the contribution / *tabarru'* and the operator does not share in any underwriting surplus arising.

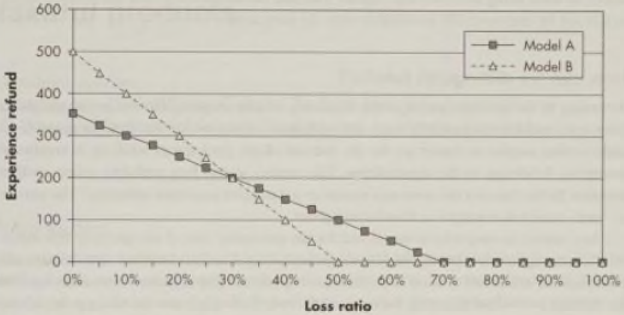
Exhibit 4.1 plots the experience refund to the participant for a premium of 1,000 and various loss ratios.

It can be seen from Exhibit 4.1, in this particular example, that as long as the loss ratio is below 30 per cent, the participant is better off with Model B with the higher *wakala* fee and no sharing of underwriting surplus.

Therefore, from the participant's perspective, it is not always clear that having the operator share in the underwriting surplus provides the participant with the best value proposition.

Exhibit 4.1

Interrelationship between *wakala* fee and level of experience refund to participant



Source: Author's own

The operator's perspective

How does the *takaful* operator determine the appropriate *wakala* fee to charge?

The *wakala* fee is usually determined as the sum of:

- management expense;
- distribution costs including commission (where this is met from the *wakala* fee); and
- profit to the operator.

What determines a fair profit to the operator? The standard benchmark of profitability for an enterprise is return on equity (ROE). Given a certain ROE requirement, the bigger the capital required to write the business, the higher the profit margin required for a set volume of business. Thus, if the statutory solvency requirement for *takaful* is high, the profit margin to the operator would need to be correspondingly higher.

A factor determining the targeted level of ROE percentage is the volatility of the return. If, for example, there is greater volatility in return, an investor would target a higher ROE percentage than if the return is stable and predictable. That is part of the reason why investors demand a higher return for their investment in quoted equities (which normally demonstrate high volatility in year-to-year return) than for bonds (which provide a fixed, predictable return).

Given a scenario where surplus and deficits are on the participant's account and where the operator's solvency requirements (and thus capital requirements) are not excessive, it is possible to charge a low *wakala* fee, thus benefiting the participants.

A reason sometimes quoted as favouring Model A described above (with incentive compensation) is that it takes a higher loss ratio (70 per cent in the above example) before a deficit (and therefore the need for a *qadrul hasan* or financing from the operator) is incurred. This is true. However, consider the following situation: if the operator's profit is dependent solely on there being underwriting surplus, then like the mudaraba model this *wakala* model would not be commercially sustainable over the long term.

How can we distinguish *takaful*?

Returning to the question posed at the beginning of this chapter, 'How does *takaful* differ from conventional insurance?', then my preferred answer would be that, in *takaful*, all underwriting surplus or losses are for the account of the participants while in conventional insurance, it belongs to the shareholders. This answer would then probably solicit another question. Is this then not the same as a mutual or cooperative insurance company? The answer is, 'yes', except that *takaful* is *Shari'a* compliant.

Is a mutual or cooperative model bad for the consumer? No; if run properly this model would instead provide a better return to the policyholder. Conflicts between shareholders and policyholders are bound to arise in an insurance operation. The regulator often finds itself in the difficult position of balancing the needs of the two. Solvency issues aside, the policyholder is better served in a mutual than in a proprietary setup. The *takaful* alternative, in my view, provides a very 'neat' solution in catering to the needs of the consumer and the shareholder. It is better than the mutual model for the participants, in that shareholders bring expertise and immediate capital to the table for a fixed price (the *wakala* fee, no surplus sharing) in addition to all surplus accruing to the participants. For the shareholders, there is less need to bring significant capital to bear and the profits from the operation are more likely to be predictable and stable.

Finally, for the advocates of consumerism, *takaful* brings transparency to the table. Insurance is one of the few institutions left where its operation is often compared to a 'black box': very few people understand what goes on in that dark space. Large insurance clients and corporations already insist on knowing how much of their premiums go to intermediaries, to the insurer and its profit, and to claims. Under *takaful*, this information is also laid bare to the lay consumers.

Chapter 5

The development of comprehensive *takaful* products

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Introduction

There are a large number of *takaful* operators in the world which maintain composite licences and thus are authorised to manage both family *takaful* (or life insurance) funds and general *takaful* (or non-life insurance) funds. Few of them, however, have yet made maximum use of their advantage compared with conventional insurers. Although there are absolute differences in treatment of participants' contributions and restrictions on investment of *takaful* funds, key features and marketing strategy of the existing line-ups of *takaful* products which are currently available in the market (such as mortgage-reducing term *takaful* (MRTT), property *takaful*, motor *takaful*, and the like) are not terribly different from similar conventional insurance products. This chapter intends to create a basic framework for future development of various comprehensive *takaful* products,[1] the ultimate version of which would cover almost all risks, both life and non-life insurance risks under a single *Takaful* Certificate (or an insurance policy).[2]

Takaful for all people

> When an Arab Bedouin asked the Holy Prophet, 'Shall I leave my camel untied and seek Allah's protection on it, or should I tie it?', the Holy Prophet replied to him, 'Tie your camel and then depend on Allah'. – a Hadith

Takaful, usually translated as Islamic insurance, *Shari'a* compliant insurance or Islamic alternatives of insurance, was originally invented by, and developed for the convenience of, Muslims. *Takaful* tries to eliminate such elements which are against the teachings of Islam (such as interest or usury, gambling and excessive uncertainty) as much as possible from its contracts and thus gives religious comfort to Muslims. However, in reality, not an inconsiderable number of non-Muslims in Asian counties, particularly in Malaysia, also enjoy the comfort of being participants of *takaful* schemes. In view of this fact, it can be said that *takaful* gains the attention of the public as a more fair and transparent insurance system than conventional insurance. The latter may often be considered as a 'black box', because policyholders usually do not know how the insurance companies utilise their premiums or what are the companies'

investment returns on this amount. In this context, it would be more appropriate for *takaful* practitioners to define *takaful* simply as *takaful* and it should be widely promoted to all people – both Muslims and non-Muslims – as an effective, fair and transparent measure of risk mitigation.

Long-term family *takaful* products versus yearly-renewable general *takaful* products

In 2004, Malaysia, in which it is widely recognised that *takaful* is most developed, celebrated the 20th anniversary of its *takaful* industry. The Malaysian *takaful* industry at its initial stage developed in accordance with the steady growth of the Islamic housing-finance business. According to Bank Negara Malaysia's 2005 statistics for the *takaful* industry, MRTT is still the most dominant family *takaful* product, comprising 51.9 per cent of new business contributions.[3]

It is usual for Islamic financial institutions to arrange the following two *takaful* products to protect their outstanding financed amount:

- MRTT to cover death and total permanent disability (TPD) of participants themselves; and
- houseowner's/householder's *takaful* (H/HT) to cover damages/losses of mortgaged properties due to fire and named perils (NP).[4]

It is market practice in Malaysia and most other parts of the world to separately promote family *takaful* products such as MRTT and general *takaful* products such as H/HT. In addition, general *takaful* products are normally arranged on a yearly-renewable basis, while most of family *takaful* products (with the exception of some limited line-ups of family *takaful* products such as group term *takaful* products) are long-term products. In particular, MRTT is a single-contribution long-term product, which is basically arranged to cover a whole housing finance period.

The practice of providing different arrangements for family *takaful* and general *takaful* in terms of contract period is largely for the convenience of *takaful* operators. From the customer's point of view, the following questions may possibly arise:

- Why cannot H/HT be a long-term product consistent with the housing finance period?
- Why cannot a single *Takaful* Certificate cover both life risks (death and TPD) and non-life risks (fire and NP)?

In order for us to create more 'customer-oriented' products, we attempted to introduce a similar product to Japan's single-premium long-term fire insurance products for housing loans to cover the whole housing-loan period. This kind of single-contribution long-term property *takaful* product would help Islamic financial institutions as distributors to improve 'penetration rate'.[5] At the same time, it would help *takaful* operators maintain richer contributions in general *takaful* funds from the very beginning of their operation, reduce the probability of a *qardl hasan* arrangement, and also decrease the operator's administration costs associated with renewal procedures and contribution collections in subsequent years.

Development of single-contribution long-term general *takaful* products

Single-contribution rates for long-term general *takaful* products can be derived by multiplying annual contribution rates for relevant risk categories by a set of long-term multipliers in accordance with the coverage period (or insurance period). To obtain such long-term multipliers, the following elements should be taken into account:

- coverage period;
- acquisition costs of new business;
- maintenance costs of in-force business;
- net annual contribution rate (or annual risk premium rate);
- expected rate of investment return;
- expected inflation rate; and
- expected trend (up/downward) of the annual contribution rate level in the future.

Exhibit 5.1 illustrates a sample set of long-term multipliers for a property *takaful* product with the calculation based on a certain combination of the above-listed assumptions. For example, property *takaful* coverage for 30 years would be provided if a participant makes a single contribution equivalent to 17.70 years.

Exhibit 5.1

A sample of long-term multipliers for property *takaful*

Period	Multiplier	Period	Multiplier
1	1.00	16	11.75
2	1.95	17	12.25
3	2.85	18	12.70
4	3.75	19	13.15
5	4.60	20	14.00
6	5.45	21	14.40
7	6.20	22	14.85
8	6.95	23	15.25
9	7.70	24	15.65
10	8.40	25	16.05
11	9.05	26	16.40
12	9.70	27	16.75
13	10.30	28	17.10
14	10.90	29	17.40
15	11.45	30	17.70
16	12.00		
17	12.55		
18	13.05		
19	13.50		

Source: Author's own

As mentioned above, single-contribution long-term general *takaful* products would aid *takaful* operators to decrease the administrative loads of renewal procedures and contribution collections. However, using property *takaful* as an example, *takaful* operators will have to clearly prescribe in their wording in the *Takaful* Certificate their treatment in cases such as:

- partial loss, for example, whether the average condition shall be applied or not;
- increase/decrease in the sum covered (or sum insured) during the coverage period due to revaluation or expansion of the property; and
- changes in location, structure of the property or occupation to be conducted therein.

Development of comprehensive mortgage *takaful* products

A possible structure of comprehensive mortgage *Takaful* Certificate

Once a houseowner's/householder's *takaful* (H/HT) has been enhanced as a single-contribution long-term *takaful* product, then this product can be combined with MRTT to structure a possible comprehensive mortgage *takaful* product, which covers both life (death and TPD) and non-life (fire and NP) risks under a single *Takaful* Certificate. This simple product, although merely a combination of MRTT and H/HT, meeting the immediate demands of Islamic financial institutions could provide a good beginning to reach a comprehensive *takaful* product in the future.

In order to develop a flexible and portable template for global expansion, Exhibit 5.2 provides a possibility for wording for this comprehensive mortgage *takaful* in the *Takaful* Certificate.

Exhibit 5.2

A possible structure for comprehensive mortgage in a *Takaful* Certificate

Section I	Definitions of *takaful* terminologies
Section II	Fund flow and general provisions
Section III	Risk Fund (1): MRTT coverage and exclusions
Section IV	Risk Fund (2): H/HT coverage and exclusions

Source: Author's own

By structuring the *Takaful* Certificate in this way, several more risk funds as Sections V, VI, VII may be added to create an ultimately comprehensive *takaful* product at a later stage.

A possible *takaful* model[6]

For the convenience of our product design, we need to adopt a particular *takaful* business model as the foundation of our comprehensive mortgage *takaful* product. As previous chapters

have explained, there are several different *takaful* models existing in different parts of the world.[7] To decide which model to choose, the following factors should be taken into account:

- familiarity in the domestic market;
- international acceptance;
- breakeven year;
- expected product mix; and
- eventual regulatory approval.

In Malaysia, the mudaraba model is more widely known, as the modified mudaraba model is adopted by a local major player and is more common in practice. It is possible that the current modified mudaraba model will be changed (in name) to the *wakala* model. On the other hand, the *wakala* model is more internationally recognised and may be easier for us to expand internationally, if the model is used. See the discussion in Chapter 4, '*Takaful:* A question of surplus' describing each of these *takaful* models.

From the view of the *takaful* operator, it tends to take a longer time to reach the break-even point under the mudaraba model, as it takes time to accumulate sufficient assets for adequate investment income. The *wakala* model, however, collects upfront fees from day one. It is the skill of the *takaful* operator to keep actual expenses within the loadings in order to make a profit.

It is generally considered that the mudaraba model does not fit *takaful* products adopted for protection purposes, although savings products would work well within both the *wakala* and mudaraba models.

Fund flowcharts[8]

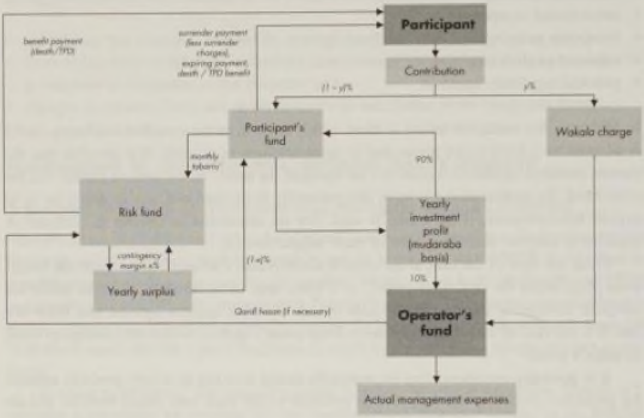
Based on the above considerations, in this section we tentatively adopt the *wakala* model (with the mudaraba element) as a possible *takaful* model. Exhibit 5.3 shows a fund flowchart for a single *takaful* fund, and Exhibit 5.4 does the same for twin *takaful* funds.

Let us take the fund flowchart from Exhibit 5.3 item by item.

- *Takaful contribution.* A single contribution shall be made by the participant or the Master Certificate Holder (usually Islamic financial institutions), if financed by the Master Certificate Holder.
- *Wakala fees.* The *takaful* operator is entitled to receive prescribed *wakala* fees for its services rendered. The level of *wakala* fees inclusive of distributors' commissions shall vary by type of coverage and be defined as per cent of the contribution (y%, in this case). The fees shall be transferred to the operator's fund. Additional *wakala* fees could be collected as a certain per cent of monthly *tabarru'* charges mentioned below.
- *Participant's fund.* After the deduction of the prescribed *wakala* fees, the remainder of the contribution ((1-y)%, in this case) shall be credited wholly into the participant's Fund. The fund belongs to each participant and is deemed as his/her savings or investment account. Upon *takaful* events, maturity or surrender, the net amount maintained in the

Exhibit 5.3

A possible *wakala* model (with *mudaraba* element)



Source: Author's own

individual participant's fund should be paid to the participant after deduction of the operator's administration charges (a fixed reasonable amount) necessary for the particular procedures.

- *The share of yearly investment profit (on a mudaraba basis).* The participant's fund shall be invested in *Shari'a* compliant instruments and accumulate with the participant's share of the investment profit. The yearly investment profit shall then be shared between the participants and the operator on a mudaraba basis, in this case, with shares of 90 per cent and 10 per cent, respectively. The participant's share shall be credited back to each participant's fund, while the operator's share shall be transferred to the operator's fund.
- *Risk fund.* The monthly *tabarru'* charges[9] shall be allocated from the participant's fund to the risk fund, by which *takaful* events shall be covered. The surplus in the risk fund shall be determined on a monthly basis. A certain percentage of the surplus shall be kept aside to set up a contingency margin (x%, in this case) and the remainder ((1-x)%, in this case) shall be distributed to all participants, with the exception of claimants,[10] on an annual basis via the participant's fund according to their paid amount of contributions.
- *Qardl hasan.* The shareholders of the operator shall arrange, if necessary, *qardl hasan* (or interest-free finance), in the event that the risk fund falls into a deficit situation with respect to solvency of the risk fund after using the contingency margin. The finance shall be repaid

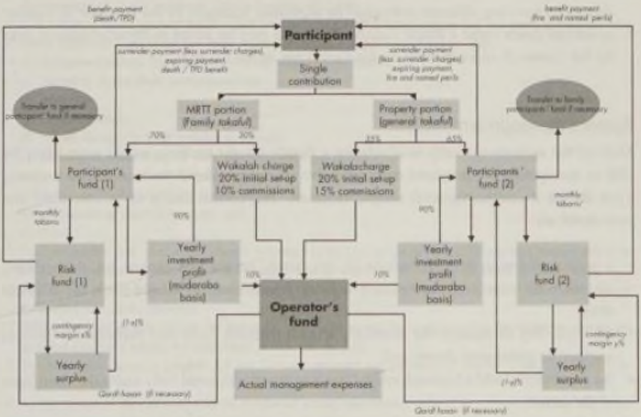
only on the original amount disbursed, from the future surplus of the risk fund, in a lump sum or on an instalment basis depending on the emerging future surplus and the amount of the finance disbursed.

- *Re-takaful*. The Master Certificate Holder (usually an Islamic financial institution) on behalf of the individual participants may authorise the operator to procure re-*takaful* to mitigate risks and thus protect the interests of all the participants. The re-*takaful* contributions shall be paid from the risk fund. In the case that the required appropriate re-*takaful* in terms of credibility and reasonable pricing may not be available, the operator could be given the right to make conventional reinsurance arrangements as necessary.
- *Operator's fund*. The operator's fund shall receive the *wakala* fees and the operator's share of yearly investment profit, and in return shall provide for all management expenses and distributors' commissions, as well as fund any *qardl hasan*, which may be required in the case of a possible deficit in the risk fund. The financed amount shall be recovered from future surplus to be generated in the risk fund.

The twin *takaful* model described in Exhibit 5.4 has many similar features to that described in Exhibit 5.3. The following are the differences:

Exhibit 5.4

Comprehensive mortgage *takaful* with twin *takaful* funds



Source: Author's own

- *Takaful contributions*. Single contributions shall be allocated to two major portions – MRTT (or the family *takaful*) portion and property (or the general *takaful*) portion, respectively. For prudent operational purposes, separate management of the family *takaful* fund and the general *takaful* fund are encouraged.
- *Wakala fees*. The *takaful* operator is entitled to receive prescribed *wakala* fees for its services rendered from each of the allocated contributions. The level of *wakala* fees, inclusive of distributors' commissions, may vary by type of coverage and shall be defined as a per cent of each allocated contribution. In this case, as an example, *wakala* fees are prescribed at 30 per cent for MRTT and 35 per cent for H/HT, respectively. Both *wakala* fees shall be transferred to the operator's fund.
- *Participant's fund*. After the deduction of the prescribed *wakala* fees, the remainder of the allocated contributions shall be credited wholly into the relevant participant's funds (participant's fund (1) and (2)) – in this case, as an example, 70 per cent for MRTT and 65 per cent for H/HT, respectively.
- *Re-takaful*. Separate re-*takaful* shall be arranged for risk fund (1) and risk fund (2), respectively.
- *Mutual transfers between different participant's funds*. A unique function can probably be embedded in this composite product. Mutual transfers from one participant's fund to another participant's fund (that is, from participant's fund (1) to (2) and vice versa where this belongs to the same person) are allowed in the event of a participant's fund being depleted to the extent that the fund is unable to meet the monthly *tabarru'* deduction.[11]
- *The addition of risk funds*. As mentioned above, for the purpose of prudent operation, the risk funds covering different risks shall be separately managed by the operator. A number of *takaful* funds under a single *Takaful* Certificate may be added to cover additional risks by the means of endorsements on the Certificate in the future.

System development

Most of the systems currently available for a family *takaful* business would most likely be able to incorporate the proposed comprehensive mortgage *takaful* product proposed above, even though it contains general *takaful* elements. The critical issues to be examined and considered are:

- a proper allocation of contributions for the family *takaful* and general *takaful* portions, and the achievement of a completely separate management of *takaful* funds for different risks;
- the capability to manage the necessary mutual transfers from one participant's fund to another, as elaborated above; and
- the flexibility to add additional *takaful* funds to cover additional risks under the Certificate in the future.

Conclusion

The comprehensive mortgage *takaful* scheme proposed here is merely one example of a possible composite *takaful* product. By properly adding more *takaful* funds to cover additional risks under a single *Takaful* Certificate, we would be able to create an ultimately comprehensive *takaful* product, which would cover almost all risks, both life and non-life, we encounter in our lives.[12] These comprehensive *takaful* products would naturally be priced cheaper than a simple bundling of various stand-alone *takaful* products. The comprehensive *takaful* products would be accepted more widely, not only because these products could eliminate Muslims' religious concerns over buying conventional insurance products, but also because their reasonable pricing could make more people afford to participate in the schemes. A single *Takaful* Certificate to cover various risks would be easily understood by the public, and eventually would help *takaful* operators promote *takaful* more widely as an effective, fair and transparent measure of risk mitigation.

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1 The proposed comprehensive *takaful* framework discussed here was under development when the author was writing this chapter. For reader's update, Bank Negara Malaysia approved this on 27th November 2006 after several refinements.

2 'Super Insurance' developed by one Japanese insurer inspired the author to contribute this chapter. The comprehensive insurance product covers almost all risks – both life insurance risks and non-life insurance risks. Both Tokio Marine & Nichido Fire Insurance Co. Ltd and Tokio Marine & Nichido Life Insurance Co. Ltd are the patentees of 'Super Insurance' (Patent number: 4622196).

3 It is followed by endowment *takaful* (13.4 per cent), investment-linked *takaful* (9.7 per cent) and medical and health *takaful* (8.7 per cent). See Bank Negara Malaysia *Takaful Annual Report 2006*.

4 In Malaysian practice, 'named perils' include such risks as follows:

a) lightning, thunderbolt, subterranean fire;
b) explosion;
c) aircraft damage;
d) impact damage by road vehicles or animals;
e) bursting or overflowing of water tanks, apparatus or pipes;
f) theft by forcible or violent entry or exit;
g) hurricane, cyclone, typhoon or windstorm;
h) earthquake or volcanic eruption; and
i) flood.

5 The 'penetration rate' used in this chapter is defined as the ratio of the number of people who participated in an MRTT scheme among whom concluded property sale agreements with the Islamic financial institution.

6 This section is contributed by Mr Hassan Scott P. Odierno, Consultant/Actuary and his team at Mercer Zainal Consulting Sdn. Bhd., Malaysia.

7 Different *takaful* models include the Sudanese cooperative model, the *wakala* model, the mudaraba model, the modified mudaraba model, the unit-linked model, and the like.

8 The flowcharts shown in Exhibits 5.3 and 5.4 were prepared and provided by Mercer Zainal Consulting Sdn. Bhd., Malaysia.

9 As the surplus in the risk fund shall be distributed among participants, there is an interpretation that this is not a 'pure' *tabarru'* but, rather, a 'conditional' one. A model exists that does not distribute the surplus even to individual participants. Under such a model, all surpluses are kept in the risk fund and any amounts that exceed conservative and reasonable reserves may be donated to charities selected and approved by the *Shari'a*.

10 There are several methods of how to treat claimants under a surplus distribution, whether claimants are included or excluded in the surplus distribution calculation.

11 No operator can guarantee the percentage of investment return assumed for pricing *takaful* products. The suggested mutual transfers function could mitigate the participant's risk in the event that his or her participant's fund cannot meet monthly *tabarru'* deductions.

12 Some savings-type general *takaful* products, such as savings-type fire *takaful* and savings-type personal accident *takaful* with three, five and ten years' maturity periods (popular in the Japanese market) could also be brought into the Malaysian market, if demand is created.

Chapter 6

The role of pure re-*takaful* operators versus conventional reinsurers: envisioning the future

Chakib Abouzaid
Takaful Re

Introduction

The re-*takaful* is the Shari'a alternative to the conventional reinsurance. The agreement among the scholars is to consider the cession from a *takaful* company to a conventional reinsurer as a temporary exemption or by necessity (Dharura). But, now with the launching of new and sound re-*takaful* operators, use of exemption is no more needed, except for the large risks or for those who needs a specific expertise which is not available with the new re-*takaful*.
The re-takaful capital allows the company to be registered and accepted by the insurance supervisors and to get an acceptable rating.
A re-*takaful* company must follow the following criteria:

- *Shari'a* board is a must;
- shareholder's and policy holder's accounts segregation and commitment to the surplus distribution;
- underwriting *Shari'a* accepted risks (no alcohol, no gambling...); and
- investment in *Shari'a* compliant instruments.

From the underwriting point of view, the conventional reinsurance is a pure risk transfer from a direct company to a reinsurer. The re-*takaful* company is managing the pool for and on behalf of the direct *takaful* operators.

The technical assessment of the risk and the acceptance are using the same standards for both conventional and re-*takaful*. However, as the re-*takaful* is new and focusing only on the *takaful* companies, a special attention is paid to make them more competitive with the conventional direct insurers.

Background

The *takaful* industry is young, formally since 1979. Throughout the subsequent 27 years its growth continued to be robust. *Takaful* has extended even to the West which now has its own population of Muslims, teeming millions of émigrés from the Muslim world; now citizens

and part of the much more secular West. Re-*takaful* has grown along with it. Re-*takaful* started in 1985 in a difficult context. Few direct insurers then were working on an Islamic basis with or without re-*takaful*. None of the first three re-*takaful* operators was able to survive without accepting 'conventional' business. In the 1980s, the re-*takaful* companies were based on a hybrid model which bore no relation to any of the direct models now existing. *Takaful* operators now attract considerable interest and in turn there is an awareness of the need for re-*takaful* together with an overriding concern for *Shari'a* compliance. These are key elements of the strong adherence to the community's first principles and its need for *takaful*.

This chapter describes the history and the changes that developed along the journey to the establishment of the fully-fledged *takaful* industry, and what lessons can be learned for the future. This chapter hopes to create a vision of re-*takaful* as bedrock for *takaful* and the betterment of the community.

History

Takaful began in 1979 in Sudan and Saudi Arabia. The need for Islamic solutions for Islamic banking transactions pioneered this phase. Two groups were interested in developing an insurance offer based on the *Shari'a*: Bank Fayçal and the Al Baraka group.

In 1985, Al Baraka launched the first re-*takaful* operator BEST Re. In the following years, two other re-*takaful* operators were launched in KSA, Islamic Takaful & Re-takaful Company, owned by Dar Al Mal Al Islami and Islamic Insurance & Reinsurance Company (IIR Co).

A dynamic impetus to growth, however, came from South-east Asia. From the late 1980s onwards, the Muslim world saw *takaful* evolving considerably in Malaysia. The Malaysian *takaful* operator, Syrikat Takaful Malaysia, illustrated the swift growth of the first *takaful* portfolio in the country, all underwritten on a model which served as a platform for expansion to the other countries in Asia.

In recent years, Islamic finance witnessed new growth following the rising strength of petrol exports. New *takaful* companies started their operations in other Islamic countries: Kuwait, the United Arab Emirates, Pakistan, Sri Lanka and Malaysia.

The latest development in the re-*takaful* world is the launch of Takaful Re in Dubai, a fully-fledged re-*takaful* operator spearheading growing interest from the international reinsurers in this niche market.

Takaful industry: Characteristics

The *takaful* industry is still a small segment in a global insurance market. The global insurance market grossed US$3,243.9bn in 2004.[1] The estimate of total *takaful* contributions is between US$1,000m to US$2,000m. Information is scarce on the size of the *takaful* universe: the number of companies and their total gross written premiums. The Arig's Re Takaful *Directory*[2] counts 65 companies globally. *Takaful* operators are mostly new, local and small enterprises as befits the communal nature of *takaful*.

Apart from Malaysia with its thriving *takaful* industry, other markets are only just beginning to establish research, compile statistics and carry out market surveys. Market knowledge, research and development needs to be improved across the industry.

All or most of the human resources working for *takaful* companies have a conventional insurance background. Other than a few initiates especially in Asia, expertise is short. The effects of a dominant secular influence on the industry are twofold: the qualification for *takaful* expertise taken from 'conventional' norms, and less regard for *takaful* values and elements. Sometimes *takaful* is seen by the non-initiated participant as 'conventional' insurance redressed in Islamic terms. Such perspectives further emphasise the need for strong fundamentals in *takaful* operations.

Investment opportunities are still limited for *takaful* operators. In some countries, local regulations narrow the field for *shari'a* compliant choices. This affects *takaful* companies' bottom lines and limits their ability to provide attractive returns to shareholders.

On pricing and because of the way that *takaful* is structured through a *wakala* fee,[3] in theory, *takaful* companies have to implement higher rates. *Takaful* consumers are still very sensitive to the issue of price. This affects the bottom line of the policyholder's fund.

Takaful companies also rely heavily on 'conventional' reinsurance. This is because, first, there is only a small number of existing re-*takaful* operators. The re-*takaful* capacities they offer are not sufficient to meet the *takaful* companies' needs. Moreover, because of their conventional background, past arrangements, and market reinsurance-buying culture, *takaful* operators have a bias towards 'conventional' reinsurance supply; a more known and more familiar recourse for protection and capacity.

However, as the number and size of the *takaful* operators increase, with more focussed needs, demand for the *Shari'a* compliant reinsurance capacity is expected to grow along with the industry.

The need for re-*takaful* capacity

Since the launch of the first Islamic direct operator, re-*takaful* has been the missing link in *takaful* operations. The insurance business needs to spread the risks as a technical requirement: to reduce the claims volatility, that is, the impact of the frequency and/or the amounts of claims made. Reinsurance protects the direct insurer's assets. It is the insurance of the insurance companies. These requirements are similar for both conventional and *takaful* reinsurance operations.

Takaful operators are obliged to make their operations *Shari'a* compliant. *Shari'a* scholars provided temporary 'authorisation' for *takaful* operators to deal with conventional reinsurance operators. Only if *Shari'a* compliant capacities were not available was it permissible to use a conventional reinsurer. *Takaful* operators are required to cede to existing *Shari'a* compliant capacities, subject to their professionalism, financial strength and claims-paying ability. Existing capacities are still not sufficient to meet the demand for *Shari'a* compliant capacities.

Re-*takaful* industry characteristics

- There are few players in the re-*takaful* market. Three of these are at the time of writing committed to the *takaful* industry but follow different models and approaches. Best Re is mixing *takaful* with conventional insurance business because of the historical context of its formation in the mid-1980s. ARIL is a fully-fledged re-*takaful* company operating

Exhibit 6.1

Existing re-*takaful* operators

	BEST Re	ARIL	Takaful Re
Incorporation	• 1985	• May 1997	• December 2005
Capital (US$ million)	• 55	• 14.1	• 125
Shareholders	• Solana / Islamic Arab Insurance Company	• Syrikat Takaful Malaysia • Takaful IBB Berhad • Insurans Islam Taib	• Arab Insurance Group • Islamic Development Bank • Emirates Industrial Bank, Dubai Investments • Dubai Islamic Bank • Withaq Takaful Kuwait • Qatar Islamic Insurance • Safat Takaful Kuwait
GPW (*takaful*) (US$ million)	• 8 – 10 (2004)	• 15.37	• Projected - 15.2
***Takaful* model**		• Mudaraba • Profit sharing	• *Wakala* for underwriting • Mudaraba for the investment of shareholders' and policyholders' funds
Business model	• Conventional / *takaful* mix	• *Takaful* companies only • Shareholder's business from their shareholders	• *Takaful* companies only • Outsourcing agreement with ARIG

Source: Author's own

mainly in Asia. Tokio Marine began in 2004 as a family re-*takaful* operation based in Singapore. The most recent entrant into the market is Takaful Re, a fully-fledged re-*takaful* company operating from the Dubai International Finance Center (DIFC). Exhibit 6.1 lists existing re-*takaful* operators.

- Newcomers are opening Islamic windows or setting up new re-*takaful* operators (Labuan Re, Malaysian Re and some of the international players such as Hanover Re Takaful and Converium).
- In general, existing operators are small and medium-sized companies. Most of the players are adopting a follower strategy.
- Despite 20 years' existence, re-*takaful* is still on the 'learning curve' and learning the lessons from past experience, such as the following:
  - Without professionalism, adequate capital, rating and strategic vision, companies do not have any chance to survive in a very competitive market. Since the 1990s, two of the first three operators no longer exist: one has merged and the other ceased underwriting.
  - The re-*takaful* operation should be based on a pure Islamic model as befits the nature and intent of its founding principles. Re-*takaful* is distinct from conventional reinsurance,

Exhibit 6.2

Projected general re-*takaful* income (US$ million)

Region	2003	2004	2005	2006	2007	2008
Middle East	327,550	425,815	553,560	719,627	935,516	1,216,170
South-east Asia	39,997	51,989	67,586	87,862	114,220	148,486
North Africa	5,126	6,664	8,663	11,262	14,640	19,032

Source: Takaful Re

and it is a competitive advantage that can be exploited. Companies that continue to write conventional insurance can do so, subject to there being separate accounts for their conventional and *takaful* businesses, for the benefit of shareholders, policyholders and to comply with the *Shari'a*.

- The *takaful* niche is still small and it is a challenging task for existing operators to write only *takaful* business.

Re-*takaful* operators are challenged. They have to compete with the conventional operators to which *takaful* is a niche market opportunity. Direct *takaful* companies' managers are very sensitive to the cost argument, the rating, and their past relations with the conventional reinsurance industry. *Shari'a* requirements are not always the paramount criteria that they should be to help strengthen compliance. *Shari'a* boards should implement a 'right of first showing' to the re-*takaful* operators. Given that it is *takaful* business, it must naturally flow into re-*takaful* for spread and risk management considerations. Reinsurance by conventional arrangements disqualifies the Islamic portfolio.

In the absence of more relevant statistics, we have based our evaluation of the potential re-*takaful* market in Exhibit 6.2 from an approximation of the exiting portfolios of *takaful* companies in 2003.

It is very clear that *takaful* is still a small segment of the insurance industry. However, the number of *takaful* companies is growing and their market share will consequently increase. Broader Islamic banking shows far more dynamic growth. In the GCC countries, the number of *takaful* operators in the United Arab Emirates or Kingdom of Saudi Arabia is still limited. Many issues could explain this situation such as:

- sensitivity to the price of the cover, even from retail customers;
- the lack of differentiation from conventional insurance, except by brand name, thus affecting the credibility of the *takaful* industry;
- the nature of the insurance markets driven by financial surplus, government budgets and industrial risks, rather than personal lines and the life insurance business;
- the market's level of maturity, which is still limited and innovation is not sufficiently developed; and
- the lack of a legal framework and encouraging measures from the governments.

Challenges for the re-*takaful* industry

Market and demand knowledge

The size and knowledge of the *takaful* segment is still limited. The *takaful* industry must have a better knowledge of its existing and potential market. Demand is not gauged either by the *takaful* or the re-*takaful* companies. There is a need for market segmentation and an understanding of the the demand constituents. Re-*takaful* companies and all the operators interested in the development of the industry must make it an imperative to know their markets.

Meeting the demand

More market knowledge will enable the industry to meet the demand. It is clear that the *takaful* industry can only witness considerable growth if it can first supply the demand originating from the retail business. Consumer individuals are more sensitive to the issue of *Shari'a* compliance than corporates, which are under more imperatives to cost versus protection. If the *takaful* companies begin by competing with the conventional insurers on industrial risks, consumers will be unable to differentiate the *takaful* from the conventional. In this respect, the industry can learn from retail banking and the bancassurance. The *takaful* industry is a long-term investment.

The development of *takaful* can only be achieved through an adequate offer of personal lines and family *takaful*. This includes assistance toward the direct seeding companies in fields such as product design. The re-*takaful* operator's strategy must assist in developing such offers.

Takaful and the bottom of the pyramid

The Arabic meaning of the *takaful* concept is to help each other, or solidarity. However, at the time of writing, the *takaful* industry does not have an adequate strategy to attract those at the bottom of the pyramid. The concept is

> ... based on the notion that if you break the economic and physical bottlenecks of distribution you can reach a huge, previously neglected market .... [M]illions of small sales can, in aggregate, add up to big profits.[4]

This approach could be the base for a strategic vision for the development of the *takaful* industry. It needs a legal framework from the Muslim countries and a cross-borders approach from the investors, long-term vision and investments. Apart from the oil-rich Gulf countries, Muslim territories have an enormous, poor population. The *takaful* concept, which is close to mutuality, should target this population. This requires *takaful* companies to design low-price products, with minimal marginal costs, to be sold by less costly distribution channels in order that non-experts (salesmen who don't need to be technically highly-qualified) can deliver them. For example, the Grameen Bank in Bangladesh (Micro Credit) is to be duplicated through the local associations, trade unions and non-government organisations (NGOs).

To meet the bottom line demand, the direct *takaful* and re-*takaful* companies should innovate in terms of strategy. Shareholders must have a long-term vision rather than an opportunistic approach. Re-*takaful* companies must adapt their strategy to this new situation by being able to support those companies which are willing to develop this approach: assisting companies in designing and implementing distribution channels, and selling personal accident, motor, householder's and family *takaful* to a low-income population.

The advantage for both *takaful* and re-*takaful* companies is the limited need for reinsurance and retrocession capacity as volatility for the small and personal lines of business is limited and the loss ratio fair.

Limited capacity

The available re-*takaful* capacity is insufficient to cover all the direct *takaful* needs, despite their limited number and generally small size. There is still a need for conventional reinsurers, especially for the large risks or the specialised lines.

The dilemma for the re-*takaful* industry is the limited size of the ceded premium and the industry's capacity. Re-*takaful* companies will not grow unless they are able to increase their capacities and/or their market share. Thus, for a re-*takaful* company to focus only on the *takaful* industry is a constraint.

Yet, from the religious perspective, a re-*takaful* company cannot mix the Islamic business with the conventional, unless the company is able to ensure that the non-Islamic element of the business remains acceptable under the *Shari'a* and avoids *riba* (interests on deposits for the premium and claims reserves).

A retro-*takaful* capacity (retrocession) does not exist at the time of writing, except for the possibility of exchanging business between the three existing operators. For the re-*takaful* company, this is a constraint and the *Shari'a* principle to be applied is 'necessity'. The re-*takaful* company could temporarily use the conventional retrocessionaires because of the lack of capacity in the re-*takaful* industry. Moreover, the quality of the retrocessionaires is essential for the rating. The existing re-*takaful* companies must have in their security list a high percentage of 'A'-rated companies. Takaful Re restricted its market to *takaful* companies only, thus avoiding the mix between *takaful*, the conventional, and the problems with *riba*.

Competition with the conventional

With respect to competition, re-*takaful* operators are in a similar position as the direct *takaful* companies: they compete on a global basis with the conventional international players and

with regional reinsurers, which benefit from proximity, compulsory national cessions and/or right of first refusal (such as in Malaysia). Re-*takaful* companies have an advantage in terms of *Shari'a* compliance, but this may be insufficient to counter competition from conventional insurers, because of the size and expertise of conventional reinsurers and their historical and/or personal relations within the markets.

Pricing risks and treaties are the keys to enable re-*takaful* companies to gain substantial market share, supplementing re-*takaful* capacities with expertise, pricing tools and the ability to explore specialised, niche markets.

Re-*takaful* operators must find their own way to increase penetration by anticipating and meeting the demand from direct *takaful* companies, and building partnerships with new *takaful* start-up companies from the beginning, to secure their share of the *takaful* business of these companies.

Lack of rating

Takaful Re and BEST Re are rated by the international rating agencies. Newcomers to the market can benefit from their mother-company's rating. Re-*takaful* operators must consider the rating issue as a priority, which means fulfilling the rating agencies' requirements in terms of capital adequacy, solvency, operating performances, financial flexibility and liquidity. The rating will enhance the attractiveness of the re-*takaful* operators as established securities. An international rating has become a requirement from the regulatory bodies in many countries. It is, of course, a marketing tool for re-*takaful* operators, and it will limit the reluctance of some operators to deal with re-*takaful*, rather than traditional reinsurance, operators.

However, the re-*takaful* operator must insist, and the direct *takaful* operators understand, that the first requirement for a *takaful* company from a re-*takaful* operator is *Shari'a* compliance. The security or the rating is a general requirement for all of the insurance industry.

Human resources

The lack of human resources dedicated to *takaful* is one of the major weaknesses of the industry. This is visible especially in the Middle East and North African (MENA) region because of the recent development of *takaful*. The backgrounds of underwriting, accounting and marketing staff are in conventional insurance. This tends to negatively affect their ability to develop an appropriate *takaful* profile needed for better service to the clients and the cedant companies.

The *takaful* industry must develop a proper educational tools to ensure professionals within the industry are able to fully develop and market *takaful* products and the concept of *takaful*. Only then can differentiation develop within the industry.

Specific *takaful* regulation

The success of the Malaysian model should encourage other governments to build specific regulations for *takaful*, as well as the political goodwill to develop it. The development of *takaful* must be considered as a tool encouraging the penetration of insurance in general into new markets, and as a means to promote Islamic finance and the *Shari'a* compliant instruments for saving and protecting assets. A legal framework will clarify and standardise the rules and *Shari'a* compliance within individual countries and on a regional basis.

There is a need for a harmonisation of standards between *takaful* companies. This standardisation should occur in compliance with the International Financial Reporting Standards (IFRS) and the International Association of Insurance Supervisors' (IAIS) requirements. This will help the industry remain in line with the latest developments.

Corporate governance

Globalisation requires the standardisation of accounting methods, management and corporate governance. *Takaful* operators, as financial corporations looking for credibility, must comply with internationally accepted corporate governance principles. The need for transparency is more urgent within *takaful* companies, as they are the managers of the policyholders' as well as the shareholders' funds. As *takaful* and re-*takaful* operators are in a sense the promoters of Islamic values, they must pay maximum attention to and have great respect for the ethical aspects of *takaful* operation. Transparency and corporate governance are the basis of this approach.

Conclusion

The commitment to the *Shari'a* is the cornerstone of the success of *takaful* and re-*takaful*. This young industry must uphold its credibility with a strong commitment to the values of the *Shari'a*, with professionalism and integrity in order to differentiate *takaful* from conventional insurance business. Differentiation between Islamic and conventional insurance can be developed to great competitive advantage for the industry, with better market segmentation and understanding of consumer needs, buttressed by quality human resources and services.

Only an approach based on the values of *takaful* and professionalism can enable the *takaful* operators to compete on sound ground with the conventional insurance companies. Beginning at the base of the pyramid could add significantly to the volume of business and increase the awareness and the penetration of insurance. This will combine the values of solidarity with the economic return to investors.

The re-*takaful* industry needs to be more efficient. It needs innovative approaches to translate its latent features into strengths. The direct *takaful* operators need more than just additional capacities. They need support for innovation in their products backed by financially strong re-*takaful* operators that are well rated and playing a leading role.

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1 GWP: Gross Written Premium or contributions.

2 According to Swiss Re *Takaful Directory*: www.takaful-re.ae.

3 *Wakala* fee is a percentage deducted "up front" from the Gross Contributions. This percentage must cover all the operator (reinsurer) operational costs. The remaining net contribution is ceded to the policyholder's pool to cover the claims and acquisitions costs.
Example: 100 gross contribution: 20% Wakala + 80% to the pool.
The percantage of the *wakala* fee must be circulated to the policyholder in the beginning of the year.

4 C.K. Prahalad, *The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profit* (Wharton School Publishing, 2005). The author of this chapter acknowledges Mr Prahalad's book has contributed greatly to his own thinking about the potential of *takaful* in this respect.

Chapter 7

Concerns and misconceptions in the provision of *takaful*

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Introduction

Although the *takaful* industry is well established internationally and is expanding rapidly with many new entrants, there remains much confusion amongst the wider public, including many potential Muslim clients, about the differences between *Shari'a* compliant insurance and conventional insurance products. The general Muslim public is aware that scholars of Islamic jurisprudence, the *fuqahā'*, reject conventional insurance, but they are uncertain of the reasons why it is viewed as haram. Furthermore there is a lack of understanding as to how *takaful* providers should be organised and operate, and the providers themselves have not been effective in consumer education and marketing. Consequently, although it is easy to expand rapidly from a minimal base, further expansion will inevitably be more difficult unless potential clients are convinced of the merits of *takaful*, and can appreciate for themselves what is distinctive about this form of insurance, and why it is regarded as *Shari'a* compliant.

The provision of retail insurance and brokerage practice

The retail insurance industry is relatively underdeveloped in the Muslim world, and even amongst Muslim minorities in the West the take-up of insurance has been limited. To a large extent, this reflects the underdevelopment of Muslim economies and the lower socio-economic position of many Muslim communities in Western economies, rather than concern that conventional insurance conflicts with *Shari'a* teaching. Most usually, Muslims take out conventional insurance when it is against state laws not to be insured, as in the case of vehicle insurance, or where the insurance is a condition of obtaining financing, as with buildings insurance and often mortgage protection insurance in the case of home financing. In such instances Muslims have no alternative to purchasing insurance policies, usually from conventional providers, rather than *takaful* products, which may not be available.

Where insurance is compulsory, or a precondition for financing, the main concern of the Muslim client, as with non-Muslims, is the cost of the policy, and they may shop around themselves for the best value policy or seek the assistance of an insurance broker. Brokers usually do not charge the client for their services, rather they receive a commission from the

company where the client's business is placed, sometimes resulting in their advice being biased by their own financial considerations rather than being driven by those of the client that would imply impartiality. *Shari'a* scholars have yet to address the issue of insurance broker transparency over commissions, a real concern of many Muslim clients.

Addressing the *fuqahā'* objections to insurance in principle

Although all Muslims are of necessity concerned about *Shari'a* teaching, some believe that the *fuqahā'* are focused on esoteric issues of traditional jurisprudence which have limited relevance to the complex financial situation in which they live, where mitigating risk through taking insurance cover is seen as both normal and desirable. One basic objection of the *fuqahā'* is that standard insurance violates the prohibition of *gharar*, which involves uncertainty, as the benefits are dependent on the outcome of future events that are not known at the time the insurance contract is signed.[1] However, this applies to any form of insurance, whether *takaful* or conventional, and if this extreme position is taken, there may be a conflict between national laws, requiring, for example car insurance, and *Shari'a* principles.[2] Fortunately most *fuqahā'* now interpret *gharar* as applying to legal or contractual uncertainty, not uncertain outcomes.[3] Events such as a traffic accident or the death of a policyholder cannot usually be predicted, however risks can be assessed, and insurance premiums based on these assessments. This is the core responsibility of actuaries, whose job is to estimate probabilities of likely outcomes for a group of policyholders. Actuarial work brings social benefits, and is far from being un-Islamic.

The key principle involving the morality of insurance contracts is informed consent. Both parties, the client and the insurance provider, should be aware of the full implications of the contract they are signing. *Gharar* arises where one party, usually the insurance provider, has drafted a contract, with much so-called 'small print', burying significant clauses in a mass of information which the client has difficulty in understanding. In the worst cases, this can amount to deliberate deception, or at best the exploitation of a less informed party: in other words, the problem of asymmetric information. It should be therefore incumbent on the insurance provider to ensure that the contract is clear and comprehensible, and that the client understands the implications of what they are signing. Insurance regulators, or indeed the *Shari'a* scholars who advise *takaful* companies, cannot be present for the signing of all, or indeed any contracts, but they have a duty to read the documentation and ensure that there is no legal or contractual uncertainty.

The prohibition of gambling is explicit, the Quran in *Sura* 2.219 and 5.93 and believers can be in no doubt about this. Gambling wins are often equated with *maysir*, unearned gains, which are viewed as haram, and no *fuqahā'* would seek to justify such gains, although there has been a fatwa by Shi'a scholars that the gain from placing a bet on a horse or camel race may be legitimate if the punter takes great effort to study the form or past racing history of the runners and the jockeys, as this is time-consuming and could be regarded as a type of work. This would not apply to a game of chance however, such as a lottery, as no skill or effort is involved apart from purchasing the ticket.

Should taking out an insurance policy be regarded as analogous to a lottery, with the payment of premium representing a bet on the policyholder being a potential winner? The

argument against this is that with insurance the circumstances in which a claim is made, for example as a result of a vehicle accident, theft of household possessions or damage to a building, involve financial loss, and the purpose of the insurance pay-out is to simply compensate for this, not to enjoy a windfall gain. Of course policymakers can make fraudulent claims, but that is a matter for the insurance company, and indeed the police and the courts, and should not imply that all general insurance should be prohibited.

The *fuqahā'* have objected specifically to life insurance, the concern being that this amounts to a wager on the policyholder's death, and such matters are in the hands of Allah, not of man. Indeed there is concern over the morality of actuarial work involving the calculation of probability of death and working out premiums on the basis of this, as the old are likely to be charged more, and there may be a reluctance by commercial insurance providers to offer cover to those with a record of poor heath, or if such cover is provided to load the premium. This is regarded as an unfair penalty imposed on the weak and potentially needy.

The other way of looking at these issues is to view life insurance not from the perspective of the policyholder, but rather his or her dependents.[4] This is the concern of providers of family *takaful*, as it is seen as legitimate, indeed highly responsible and desirable, for policyholders to want to protect their families after their own deaths. Of course, like life insurance, family *takaful* can also be abused, if for example the policyholder fakes an accidental death by committing suicide. Such action would be rather drastic however, and it is in any case regarded as sinful for Muslims to take their own lives.

Mutual insurance

There has been extensive debate amongst the *fuqahā'* about corporate governance in the insurance industry, and whether insurance providers should be organised as commercial companies, with separate shareholders who profit from the premiums paid by the policyholders. Conflicts of interest may arise, as in order to maximise profits, insurance companies may want to minimise costs by restricting claims or paying out less on each claim. This is clearly against the interests of the policyholders. There is also a basic moral concern that investors in insurance companies are seeking to benefit from the policyholders' fears of potential misfortune, which is viewed as an inappropriate way of making money.

One means of overcoming these problems is to suggest that all insurance providers which are *Shari'a* compliant should be organised as mutual institutions.[5] With such organisations there are no shareholders. Rather the policyholders are the owners, and they have an undivided interest in the capital subscribed as long as they continue paying their premiums. The analogy is the membership of a club, where everyone participates. In a mutual society the members aim to pool their resources to help those members in need, with all participants having the assurance that their own needs will be met if necessary, providing there are sufficient funds pooled to finance any payouts. In a mutual society, any profits made from investing the premium income is distributed to the policyholders or re-invested to build up reserves, rather than being paid out as dividends to independent shareholders.

The policyholders will not of course make capital gains, the usual aim of shareholders, as the premiums represent expenditure for a service, the insurance provided, and not an investment. Investors in an insurance company may of course make losses, although if it is

a limited liability company they are only liable for the value of their investment. Policyholders in a mutual society may make no profits if there are substantial pay-outs, but it would be up to members to decide whether to increase their premiums in the event of a high number of claims. In other words, members of a mutual society do not have unlimited liability, but they may feel a moral duty to increase their premiums if there are a substantial number of genuine claims of increasing cost.

The major limitation of mutual societies is that they can only obtain resources from their members and cannot raise equity capital. The members are clients, not equity investors. Although some mutual insurers in the West have substantial assets, there has been a tendency towards de-mutualisation in recent years, largely because of a desire to expand the business by becoming a company and offering shares through a stock market. The issuance of equity means the companies can increase resources further by bank borrowings, further adding to resources and strengthening their financial position, providing the leverage is kept to acceptable levels.

Those who argued that *takaful* providers should be organised as mutual institutions rather than profit-making companies seem to have lost the debate, just as those who argued that Islamic finance should be provided through credit unions rather than commercial banks. The same arguments that applied against mutual organisation for conventional insurance have been used by *takaful* providers, notably the greater flexibility that raising equity capital brings rather than relying solely on premium income. There are inconsistencies in this approach, however, as although there is no *Shari'a* objection to equity investment, the sectors screened out by the Dow Jones Islamic Indices include insurance. An argument can be made that exclusion does not apply to *takaful* because it is different from conventional insurance, but any difference in how it is organised institutionally appears to have disappeared with the lack of insistence on mutual status. Furthermore any leveraging by borrowing immediately raises the question of *riba* or interest, and although under the Dow Jones Islamic Indices criteria companies can leverage for up to one third of their market capitalisation, the issue of relying on *riba* financing remains. Of course raising debt capital through other more acceptable instruments such as leasing *ijarah* or *istisna'a* project finance would be a possibility, but *takaful* companies do not do this at present.

The organisation of *takaful* with *wakala* contracts and *tabarru'* governing premiums

The main distinguishing feature of *takaful* providers is in their contractual documentation. There are two basic forms of contract, one based on the concept of *wakala*, an agency contract, with, in the case of *takaful*, *tabarru'*, which can be translated as a donation or offering, as the distinguishing feature.[6] The other contract, which will be discussed in the next section, involves a mudaraba profit-sharing arrangement. The premium paid under the *tabarru'* arrangement is like a membership fee to join a club, which may bring a private benefit to the payee and a social benefit to the other policyholders. It is different to *zakat* payments which bring a public benefit; rather *tabarru'* contributions could be regarded as a type of privatised *zakat*. With *zakat*, as with taxation, the payer does not usually have any discretion over how the revenues are spent, this being a matter for the administrative authorities which will ultimately be held accountable for their decisions by Allah – the remit for the spending being that it should benefit

the poor and needy. With *tabarru'* on a mutual basis, the payee would have a say on how the premium is used, but if it is offered by a *takaful* company, it is the management that decide. However, there should be clear criteria regarding when benefits are paid that payees should have written into their contracts, and which management should honour. As the payment is dependent upon uncertain outcomes, there is an element of *gharar* in *tabarru'* arrangements. This is permissible however, as those paying the *tabarru'* contributions are not aiming to profit from the uncertainty, the aim being the pooling of risk: risk management rather than risk-taking.

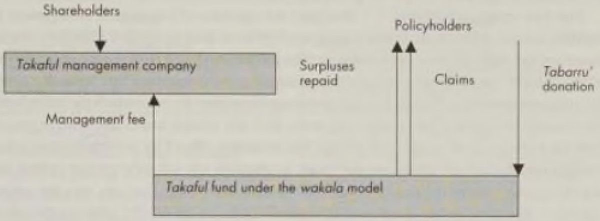
There are, however, significant legal differences between insurance based on conventional contracts and those based on *tabarru'*. In particular with the latter, a *takaful* operator would not be the owner of the fund, but merely its custodian.[7] The *takaful* operator receives a management fee for their efforts, but any surplus remaining in a *tabarru'* fund after all claims have been met belongs to the contributors, not to the management or indeed the shareholders. In theory, it is the policyholders who should be deciding whether any surpluses should be repaid to themselves, used to reduce future premiums, or added to reserves to increase the ability of the *takaful* provider to meet higher future claims. In practice, however, it is the managers who make these decisions, and in the case of a *takaful* company their prime responsibility is to the shareholders as owners, not to the policyholders contributing to the *tabarru'* fund. Needless to say there could be conflicts of interest between the shareholders and the policyholders. Building up reserves through the subscriptions of the latter and reducing the potential for losses is in the interests of the shareholders. However, while returning surplus funds to the policyholders is unlikely to be welcomed by the shareholders, even if they are not the actual owners of the *tabarru'* fund.

In *wakala* contracts, these conflicts of interest are supposed to be addressed by the provisions of the agreement. The *takaful* operators earn a fee, which will usually be around 20 to 35 per cent of the *tabarru'* contributions, and therefore the greater the fee income in relation to the operator's costs, the larger the potential dividends for distribution to the shareholders. The flow diagram in Exhibit 7.1 illustrates the relationship between the different stakeholders, notably the shareholders, the management of the *takaful* company as custodians, and the policyholders contributing to the fund through *tabarru'*.

The *tabarru'* contributors have a right to any surpluses arising after claims are met. These surpluses do not represent profits, but rather excesses as a result of fortuitous circumstances reducing the value of claims. Similarly, if there is a high level of claims, this may simply reflect unfortunate circumstances such as a hurricane, flood, fire or an increase in mortality because of the spread of infectious disease. In other words, the size of the surplus, or whether there is any, does not reflect management performance, rather the latter is measured by the net profit from fees after expenses have been covered. The aim is to separate the management risks, which are borne by the shareholders, from the insurance risks, which are borne by the policyholders participating in the *takaful* fund through their *tabarru'* contributions. This separation can be achieved legally and conceptually, but in practice share prices of listed *takaful* companies are likely to be influenced by news of catastrophes and their impact on payouts. In other words, in financial terms, the determinants of the performance of *takaful* companies may be rather similar to their conventional equivalents.

Exhibit 7.1

The *wakala* model



Source: Author's own

Operationally, what is sometimes referred to as the pure *wakala* model has the disadvantage that it is not likely to be profitable for the *takaful* management company unless the management fee is set at a high level. This may be augmented by an upfront fee payable by the policyholder, but this potentially makes *takaful* uncompetitive with conventional insurance. To overcome these limitations a modified *wakala* contract has been introduced, Bank AlJazira in Saudi Arabia being the pioneer. This allows for the *takaful* management company to share in any surplus generated by the *takaful* fund, in practice a half-way house to contracts based on mudaraba, which are considered in the following section. Unlike the mudaraba contract however, the modified *wakala* contract is not a profit-sharing arrangement, as the policyholder's contribution to the fund is classified as *tabarru'* rather than an investment premium. The aim is to provide an incentive for the operating company, not the policyholder, which will be the sole beneficiary of any claims made.

Takaful contracts based on mudaraba

Under the mudaraba model, the shareholders and policyholders both share in any surpluses generated by the *takaful* fund. The size of the surpluses, or indeed whether there will be a surplus, cannot be known in advance, but the proportionate shares should be stipulated in the contractual agreement. The shares are not necessarily determined by the relative proportions of capital contributed, as the policyholders are not investors but simply purchasers of insurance protection, while the shareholders could be regarded as financiers. This corresponds to a traditional mudaraba contract where only one of the parties provides the finance. However, with the traditional contract, the other party provides management or entrepreneurial skills, but with a *takaful* contract based on mudaraba the other party provides only the insurance premium. The amount provided by the *takaful* operator to the fund will depend on the anticipated claims and the resources the operator has, which are ultimately determined by the size of the

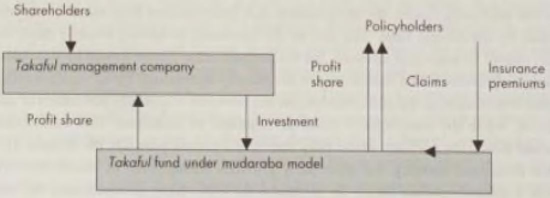
equity capital and the operator's ability to raise external funding. It is the surpluses invested in the *takaful* fund prior to and subsequent from claims being made that will generate the revenue from which profits can be shared out, but it is important to note that the surpluses will be much larger than any profits generated from their investment.

The flow diagram in Exhibit 7.2 illustrates the structure of a mudaraba arrangement for providing *takaful*, with the mudaraba concept applied to the fund in which the *takaful* company invests and the policyholders pay premiums. The profits are shared between the policyholders and the *takaful* management company according to a pre-determined and mutually agreed ratio, although in practice the management company determines the ratio which the policyholder either accepts on signing the *takaful* contract or does not accept, and is therefore uninsured. There are some parallels to the 'with profits' life insurance offered by conventional insurance companies in the case of family *takaful* cover, as although the *takaful* company cannot alter the proportionate shares in the profit once the contracts are signed, they can vary the amount distributed depending on the claims and anticipated claims on the *takaful* fund and the returns on investment by the fund. As with investment mudaraba deposits with Islamic banks (where there may be a conflict of interest between shareholders and the depositors), a similar conflict can arise with *takaful* between the shareholders looking for dividends and capital gains, and the policyholders seeking a profit share.

The key issue for the policyholders is the transparency of the *takaful* fund and the extent of financial reporting on this. The *takaful* management company will need to have its own accounts audited, as this is a regulatory requirement in all jurisdictions. However, the primary purpose of the financial statements is to report to the shareholders, not the policyholders, who have an interest in the *takaful* fund, but not the management company. Conventional 'with profits' policies are notoriously opaque with regard to the criteria they use in determining 'with profit' payouts, with complicated and obscure relationships between the profits declared annually and the terminal bonuses. As *takaful* insurance is supposed to be inherently ethical, *Shari'a* scholars serving on the boards of such companies should insist on a high level of transparency and accountability in the interests of policyholders.

Exhibit 7.2

The mudaraba model



Source: Author's own

Exhibit 7.3

Comparison of the benefits of the *wakala* and mudaraba models

Wakala	Mudaraba
• Surpluses repaid to policyholders	• Profit-sharing by policyholders
• Fee income for management company	• Profit-sharing by management company
• *Takaful* fund to cover claims only	• Profits taken from *takaful* fund
• Profitability of management company depends on its fees minus costs	• Profitability of management company influenced by investment performance of *takaful* fund
• *Tabarru'* subscriptions represent donations	• Premiums paid for *takaful* cover and a profit share
• Upfront fees may be charged to the policyholder to compensate the *takaful* operator	• Fees lower and may be more competitive with conventional insurance than pure *wakala*
• Funds invested for shorter periods as surpluses repaid after claims paid, but some retained as contingency reserves	• Funds invested for longer term with performance incentives for the management company
• Suitable for household and vehicle cover and general insurance	• Potentially more suited for long-term savings plans and family *takaful*, although some believe a modified *wakala* contract is preferable for these purposes.

Source: Author's own

Operational issues

There are a number of operational issues that arise in the case of *takaful* that do not apply to conventional insurance companies, not least the need to avoid *riba*. Insurance companies hold a significant proportion of their assets in bonds or floating rate notes, which in many respects are well suited to their needs, as the maturity value is known, the only risk being of default. Although bonds and notes can, of course, be traded conventional insurance companies attempt to match the length to maturity of their assets with their anticipated payments obligations. This cover ensures they are financially sound. In recent years, given the increased volatility of both mature and emerging equity markets, there has been a tendency to increase the proportion of bonds and floating rate notes to at least 40 percent of total assets, and in some cases 50 percent, and reduce the share of equities in the total. Equities can ensure capital gains in the long term, unlike bonds, but with some downturns in equity markets lasting a decade or more, as in the case of Japan in the 1990s, and with major western markets still below their 2001 peaks, there has been a flight to the safety of fixed and variable income securities.

The problem for *takaful* companies is that they cannot hold conventional bonds or notes as the interest returns equate to *riba*. The obvious solution is to hold Islamic securities or *sukuk*, most of which are either *murabaha*-based and therefore financially similar to bonds,

or *ijarah*-based with variable returns, the corresponding conventional instrument being a floating rate note. In Malaysia, the substitution of *sukuk* for bonds and notes is not a problem, as there are hundreds available denominated in ringgit, with active trading in *sukuk* for over a decade. The position in the Gulf is very different, with relatively few *sukuk* available until recently, and negligible trading, as those who subscribe to these issues in the first place, usually Islamic banks, hold onto these securities given the absence of other liquid assets available that are *Shari'a* compliant. A further complication is that many of the *sukuk* in the Gulf are US dollar denominated rather than being in local currencies in which *takaful* company liabilities are denominated. Although Gulf currencies are pegged to the dollar, there is no guarantee that this peg will remain fixed in the long term, especially if a significant proportion of payments for oil and gas imports ceases to be made in dollars, as is likely when the Chinese and Indian currencies become more fully convertible.

Another operational issue is whether conventional insurance companies can offer *takaful*, the parallel being with conventional banks offering *Shari'a* compliant products through dedicated windows, counters or branches. The advantage would be the huge resources that major insurance companies have and their brand strength that provides assurance to potential clients. This advantage is undermined by the prohibition of any co-mingling of funds within the institution. If assets that were obtaining a return based on *riba* were present in a *takaful* fund, this would of necessity be haram. However, if the *takaful* fund is kept separate from the *takaful* managing company, which could be conventional, this would potentially be acceptable. Given that there is a greater separation with the *wakala* model, as only the policyholders are subscribing to the fund and the only transaction between the fund and the management company is the payment of a fee, this is arguably preferable to the mudaraba structure, where the management company is an investor in the fund. Some *Shari'a* scholars may still regard the source of these funds as impure or tainted if the conventional *takaful* provider is earning income from *riba*.

Legal and regulatory issues

Malaysia

Few countries have special laws governing *takaful*, the first specific law being the *Takaful* Act of 1984 (Act number 312) of Malaysia.[8] This defined and classified *takaful* business: the major categories being family solidarity business, general *takaful* and re-*takaful*, the latter corresponding to reinsurance or underwriting. Under section 4 of the Act *takaful* can only be offered by either companies as defined in the Companies Act of 1965, and therefore subject to its provisions, or societies registered under the Cooperative Societies Act, and thereby subject to its provisions. The purpose of the Takaful Act is to provide for a procedure for the registration of *takaful* providers, and to establish the conditions under which they operate. Section 6 of the Act is crucial, as this stipulates that the operations must conform to *Shari'a* principles and that the *takaful* operator must establish a *Shari'a* committee to monitor its activities for compliance. It is the responsibility of the committee to ensure dealings are halal, and not the responsibility of those enforcing the Company or Cooperative Societies Acts, nor indeed the Takaful Act.

Under section 15 of the Malaysia Takaful Act operators must establish a register of *Takaful* Certificates, which are the insurance policy documents stating the entitlements of the policyholders. These represent the liabilities of the *takaful* operator, which must be retained for inspection as required. Section 16 of the Act states the conditions governing the *takaful* fund that the operator should establish for family business, in particular that no surpluses should be distributed from the fund without the approval of a qualified actuary. This ensures that the long-term interests of the certificate holders are not undermined by excessive short- term distributions of revenues. Where a fund is wound up, the certificate holders have the first claim over any remaining assets. The two other most significant provisions of the Act are section 17, which deals with the separation of the *takaful* fund from other assets of the operator, and section 21 that establishes a *takaful* guarantee scheme that is financed by a levy imposed on the *takaful* operators. Funds under this scheme can be used to compensate *Takaful* Certificate holders in the event of a *takaful* operator becoming insolvent. Happily, this has not arisen in over two decades of *takaful* experience in Malaysia, a period in which the average growth of assets managed has been a remarkable 58 per cent per annum.[9] The value of family *takaful* assets exceeds US$10bn, and new contributions have risen to over US$400m annually.[10]

Although having a specific *takaful* law seems appealing and appropriate, other Muslim countries have not followed Malaysia's lead. It can be argued that the provisions of the later Insurance Act of 1996, which covers all insurance companies and not just *takaful* operators, are more significant. The issue is how much value is added by having a specific *takaful* law, and whether it is simply best to have some references to *takaful* in the existing insurance laws, or indeed tackle the issues at the regulatory level only. A legal framework may be regarded as unnecessary, or perhaps needlessly restrictive. In practice most of the provisions of the Takaful Act are concerned with the conditions for registration, which are virtually identical to those for conventional companies and which have been superseded by the 1996 Act. From 2005, Bank Negara, the Central Bank of Malaysia, required *takaful* brokers and loss adjusters to join the same association as their conventional counterparts, although, as most brokers are involved with both conventional insurance and *takaful*, this provision will not make much difference.[11] Four specialist broker licences are being issued to those dealing exclusively with *takaful* to encourage the industry's development, and four joint *takaful* ventures involving Malaysian and foreign partners have been authorised. How much business this generates remains to be seen.

Bahrain

Bahrain does not have a specific *takaful* law, but the Central Bank (formerly The Bahrain Monetary Agency) has introduced special regulations for *takaful* regulation. These describe the expected characteristics of the *wakala*- and mudaraba-based *takaful* operations, and specify that the current practice in Bahrain is to use the *wakala* model for underwriting activities and the mudaraba model for the investment activities of *takaful* companies.[12] Some commentators are critical of this so-called mixed model and would like to see a unified set of principles.[13] However the Bahrain Central Bank, like Bank Negara, does not specify the rules as to what constitutes a *takaful* product, this being a matter for each firms' *Shari'a* supervisory board.

As in Malaysia it is obligatory to have such a board. *Takaful* operators must obtain a license to undertake business, but apart from having a *Shari'a* board, all the other regulations are identical to those for conventional insurance companies operating in Bahrain, including the solvency requirements, record-keeping and rules governing matching assets and liabilities to avoid excessive maturity mismatches or currency exposure. The provisions for reporting and financial crime are also the same as for conventional companies, although there is an additional requirement that the policyholders must be informed of the *wakala* and mudaraba fees paid to the *takaful* operator.[14] The *wakala* fee should be proportional to the costs associated with establishing and maintaining the contract.

Although much is left to the discretion of the *Shari'a* boards of the *takaful* operators, and Bahrain can be regarded as an example of a light regulatory environment, the rules are specific where it matters, especially with regard to the disclosure of information to policyholders. In some respects, the regulations in Bahrain are more developed than those in Malaysia, despite the latter having a long-established *takaful* law.

Saudi Arabia

In both Bahrain and Malaysia, the situation is better than in Saudi Arabia, where the long awaited insurance law passed by Royal Decree in 2004 was a disappointment from a *takaful* perspective.[15] The law is very general, and contains no reference to *takaful*. There seems to be confusion in the title, as although it is supposed to cover insurance companies 'operating in a cooperative manner', it is not clear what this means, especially as the law refers to joint stock companies, not mutual societies. The regulations issued which accompanied the law are more comprehensive, defining different types of insurance, the conditions for licences being granted, corporate governance and regulatory and supervisory procedures.[16] These seem satisfactory, and in many respects are a sound set of regulations, but again there is no specific reference to *takaful*.

Pakistan

In 2005, Pakistan introduced the most detailed rules governing *takaful* of any country, and it is clear from these that lessons have been learnt from the experiences in other jurisdictions. These rules were issued under section 167 of the Insurance Ordinance Number 39 of 2000 rather than being a separate piece of legislation.[17] Significantly, under section 5.2 the rules permit conventional insurance companies to open *takaful* windows after five years, presumably from 2010, but until then the rules provide an excellent framework for purely *takaful* companies to operate. As a consequence Takaful Nasional of Malaysia has formed a joint venture with Pakistani partners to provide *takaful* services[18] and the Qatar Islamic Insurance Company has established two ventures in Pakistan, one for general and the other for family *takaful*.[19]

Provision is made under section 8 of the Takaful Rules of Pakistan for participants' *takaful* funds to be established, regardless of whether the *wakala* or mudaraba model is used, and, under section 9, the remit of the participant's *takaful* fund is spelt out, including what may be included in income and outgoings. It is specified in section 10.2 that the *takaful*

operator's fees shall not be determined with reference to the surplus in the participant's *takaful* fund, which could be to the detriment of the policyholders. Where there are insufficient funds in the participants' *takaful* funds to meet all claims, section 11 provides that a *qadrul hasan* (an interest-free beneficial loan) may be made from the shareholders' funds, or in other words the operating company. Rules for the sharing of the surplus in the *takaful* fund are provided under section 14, with the surplus determined each accounting year. A proportion may be held back from distribution and placed in a contingency fund to meet future claims. Rules governing the *takaful* operator are also provided, the most significant of which is under section 25, which states that the assets of the participants' *takaful* fund shall be kept separate from those of the *takaful* operator.

Takaful case studies

The Saudi Arabian law and regulations were aimed to open up the Kingdom's insurance market, as hitherto under a previous Royal Decree the National Company for the Cooperative Insurance (NCCI) enjoyed a virtual monopoly.[20] As this is the largest insurance provider in the Arab world, it is interesting to consider its operations to see if they correspond to those of a *takaful* operator. The company was established in 1986 with an authorised capital of US$133m, half of which was paid up. The sole shareholders were Saudi Arabian government agencies, the Public Investment Fund owning 50 per cent, the General Organisation for Social Insurance 25 per cent and the Retirement Pension Agency 25 per cent.[21] In December 2004, however, the company launched an initial public offering on the Saudi stock market, selling off 70 per cent of its shares, leaving the government agencies with a minority shareholding.[22] The share offering, which was worth US$383m, was heavily oversubscribed, and subsequent movements in the share price have taken the market capitalisation to over US$1bn, but today, apart from the title, it is difficult to discern what constitutes the cooperative feature of the company.

Insurance is controversial in Saudi Arabia given *Shari'a* prohibitions, and NCCI is careful in how it describes its products. There is a *Wafaa* Program for Family Savings, which could be thought of as family *takaful*, but the term *takaful* is not used. The policy seems to combine some of the features of a health protection plan with that of life insurance, as family members are paid benefits if the policyholder dies of natural causes or is killed in an accident, and if he becomes incapacitated and unable to work, benefits are also paid to the family. Payments can be made into the plan by monthly instalments, with benefits of up to US$200,000 paid on the death of the policyholder, and a loan of up to 80 per cent of the amount paid if unexpected financial obligations arise. There is a single premium option where a policyholder can purchase protection of double the sum paid in, the minimum premium being US$6,667. The other major plan offered is to cover the costs of higher education, usually abroad as such education is free for Saudi citizens at state universities in the Kingdom.

The leading specifically-designated *takaful* companies are Solidarity based in Bahrain, with a paid-up capital of US$100m, the National Takaful Insurance Company of Kuwait with a paid-up capital of US$20m and Syarikat Takaful Malaysia Berhad, which operates primarily in Malaysia, but also conducts some business in Indonesia and Sri Lanka. The total assets of Syarikat Takaful Malaysia Berhad were worth over US$650m in 2005, with an annual net

profit of US$8.3m after payment of *zakat* and taxation. All these companies are small, with Syarikat Takaful Malaysia Berhad providing the widest range of services including family *takaful*, a mortgage protection plan, an annuity scheme, a plan for education expenses and medical *takaful*. General *takaful* schemes cover vehicle accidents, fire, engineering equipment and buildings and contents. Its plans are marketed through Bank Islam Malaysia under an agreement announced in March 2006.[23]

It is evident that the newer *takaful* providers in the Gulf can learn much from the over 20 years of experience of Syarikat Takaful Malaysia Berhad, although the latter remains a relatively small company. Solidarity has increased its authorised capital to US$500m and is developing its products, with its family *takaful* range covering *Hajj/Umrah*, marriage, education and family protection, and it offers a bond fund under an agreement with Friends Provident International. The bonds involved are neither conventional or *sukuk* securities, but rather being based on *Shari'a* compliant equities and other investments. Solidarity is also involved in a joint venture in Malaysia, MAA Takaful Berhad, which is jointly held by MAA Holdings with a 75 per cent stake and Solidarity with a 25 per cent stake.[24] Solidarity products will be offered through MAA Takaful Berhad branches, which should be a good learning experience for all the parties. Despite these favourable developments in Bahrain, the major boost to the industry in the Gulf however would be if NCCI of Saudi Arabia started to offer designated *takaful* products. This seems some way off.

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Part III

Business development and distribution issues

Chapter 8

Takaful business models

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Introduction

Takaful has its origins laid down in the Holy Quran and the Sunnah. The name *takaful* originates from the Arabic verb 'kafala', meaning to guarantee. For many, the term *takaful* is relatively new, however the concept can be traced back many years and it was known to be practised by the Muhajirin of Mecca and the Ansar of Medina following the Hijra of the Prophet (PBOH) for over 1,400 years. *Takaful* is derived from the Arab customary practice of *'asabiyaa* (tribal solidarity) and diyya (compensation or blood money). Many Islamic scholars agree that *takaful*, which is based on the concept of *ta'awun* or mutual assistance, is fully consistent with *Shari'a* law.

Takaful is broadly similar to conventional mutual insurance in that it involves a number of participants sharing risk on a cooperative basis. In recent years, the *takaful* market has witnessed a dramatic rise in consumer awareness and this has led to a number of different types of Islamic models, each reflecting a different experience, environment, territory and even a different scope of thought.

There are four models currently in practice. These are:

- *al mudaraba* model;
- *al wakala* model;
- *ta'awuni* model; and
- non-profit model.

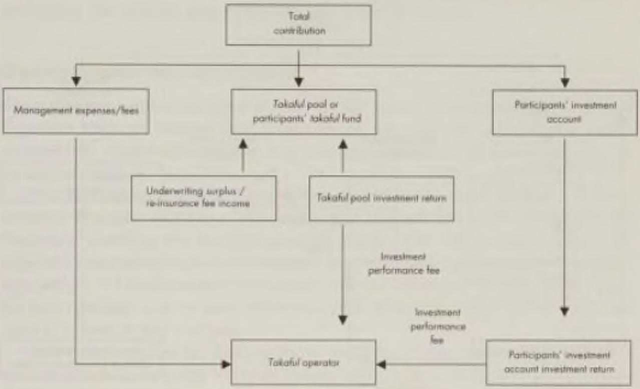
Each *Shari'a* school of jurisprudence has different views on the most suitable *takaful* model. In practice, *al wakala* (agency) and *al mudaraba* (limited partnership) are the two main models that have been adopted commercially. Both these models are used extensively in the areas where there is an expanding *takaful* market, Asia and the Middle East.

Al mudaraba model

Under the *al mudaraba* model, the *takaful* operator is entitled to an agreed fixed percentage of any investment profits which will be paid into the policyholder's (participant's) account. Generally these risk-sharing arrangements allow the *takaful* operator to share in the favourable investment performance of both the participant's *takaful* fund and the participant's investment account. However, if there are losses in the participant's special account, the *takaful* operator

Exhibit 8.1

Al mudaraba* model for life *takaful



Source: Author's own

provides an interest-free loan (*qadrul hasan*) that has to be repaid when the participant's special account returns to profitability and before any future surplus is distributed. Exhibit 8.1 illustrates the *al mudaraba* model for life *takaful*.

There is still some debate among *Shari'a* scholars as to whether the sharing of any underwriting and reinsurance fee income surplus between the *takaful* operator and policyholders (participants') is *Shari'a* compliant. Until such time as there is consistent agreement on this matter, it is best to avoid distributing insurance fee income.

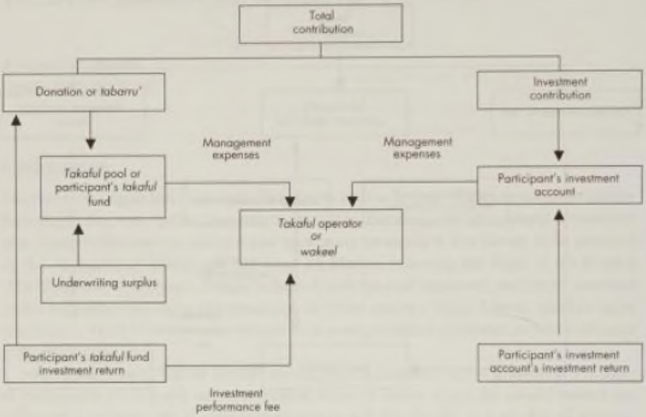
Al wakala model

Under the *al wakala* model, the policyholder (participant) places their contribution into a pool as a donation (*tabarru'*) and not a premium. The *takaful* operator which acts as an agent or *wakeel* of the policyholders (participants) is entitled to a fee that is deducted from the contributions made by the policyholder (participant) into the participant's special account.

The *al wakala* model also permits the *takaful* operator to levy a fee against the investment profits derived from investing the participant's special account, as well as a fund performance incentive fee. Significantly, the *takaful* operator (*wakeel*) does not share in any underwriting

Exhibit 8.2

Al wakala* model for life *takaful



Source: Author's own

surplus or profit, which will be distributed exclusively to the policyholders (participants). On the maturity of a *takaful* life policy or early surrender, the policyholder (participant) receives the balance of his account. If the policyholder (participant) dies early, the beneficiaries receive the balance of his account, plus the sum assured, which is defined at inception.

Consistent with the tenets of Islamic law, all charges, fees and profit-sharing percentages of both *al mudaraba* and *al wakala* are declared at the outset of the contract and are therefore transparent to all parties involved.

Ta'awuni model

The *ta'awuni* model originated in Sudan and Saudi Arabia in 1979, when Islamic scholars recognised the need for cooperative insurance. *Ta'awuni* practices insurance of pure mudaraba, where it encourages Islamic values such as unity, mutual cooperation and solidarity. The *takaful* operator and the policyholder (participant) share the direct investment income; the policyholder (participant) is entitled to 100 per cent of the surplus with no deduction made prior to the distribution. The model is applied to life *takaful* as the fund is entirely distributed to the policyholders (participants).

Non–profit model

This model includes social government-owned institutions and programmes operated on a non-profit basis which utilise a contribution that is 100 per cent donation (*tabarru'*) from participants who willingly give to less-fortunate members of society.

Bancassurance and banca*takaful*

The real pioneers of bancassurance were the British, with the creation of Barclays Life in September 1965, yet bancassurance at the time was not a great success until the concept attracted other major banks in Europe. Since then bancassurance has seen tremendous growth on a global scale.

The term bancassurance is a French word, where it has long been popular as a form of insurance instrument distribution. Bancassurance is a combination of the word "banc" and "assurance" signifying that the same institution provides both banking and insurance. The usage of the word bancassurance has increased in recent years as banks and insurance companies have merged and banks sought to extend their consumer offering to include insurance. This has been especially so in the more liberalised markets of the United States, Europe and more recently in parts of Asia and India.

While bancassurance has grown in stature during recent years, the term banca*takaful* is yet to receive the same profile within the financial services sector, yet its positioning is much the same. While bancassurance can be clearly linked to conventional banks and conventional insurance companies, banca*takaful* can be similarly linked to Islamic banks and Islamic insurance companies. The reason for establishing such a relationship remains the same – to build and develop mutually beneficial streams of revenue, while at the same time satisfying the client target market.

Research has shown that insurance is an important source of fee income for banks. In 2004, BNP Paribas Assurance announced €11.4bn in premium income with 29 million people insured around the world.[1] In 2001, more than 50 per cent of the banks in the United States earned fee income from insurance sales that aggregated US$3bn.[2]

In this context, banca*takaful* offers an exciting opportunity to both Islamic banks and Islamic insurance companies. Many Islamic banks have capital below US$100m and therefore they could benefit greatly from the added source of revenue from the sale of *takaful* insurance to their clients.

Bancassurance has shown strong growth that can be attributed to the individual interests within the relationship and the mutual benefit to all parties. The advantages to the insurance company include the following:

- The insurance company extends its customer base through increased distribution channels. It benefits from access to clients previously closed to them. This in itself is a strong recommendation for the insurance company.
- *Geographical coverage*. The bank can attract clients in a territory where the insurance company had little or no presence.

- *Demographic reach.* The bank clients may form a different age/gender group to the one the insurance company has previously courted.
- The insurance company can vary its own distribution methodology and expand its market reach, avoiding dependency on a single channel.
- The insurance company can leverage on the trustworthy name and reputation of the bank.
- The insurance company benefits from reduced distribution expenses relative to the cost of traditional direct sales distribution. The reduction in expenses has been recognised by bancassurance institutions and this has carried over into other areas of operations including products. As a result in cost reduction the products can be made more affordable to the clients.
- An insurance company is able to establish itself more quickly and more efficiently into new markets, using the existing bank distribution network.

There are many advantages also for the banks:

- The bank is able to benefit from a new source of revenue and diversification of its existing business activities. With increased competition, pressure on costs and a reduction in traditional bank revenue, banks need to look for new business opportunities to enhance profitability and increase productivity.
- The financial benefits to a bank's performance can flow in a number of ways, such as:
  - increased income generated in the form of distribution revenue and/or profits from the business;
  - reduction of the effect of the bank's fixed costs, as they are now spread across the insurance relationship; and
  - opportunity to increase productivity of staff as they have the ability to offer a wider range of products and services to clients.
- Banks are able to offer multiple financial instruments to its clients. The odds of losing a bank's client diminish dramatically when more than one product or service is purchased from the bank. Increasing the bank's product range increases client loyalty and client retention.
- The concept of a one-stop shop for clients maximises the use of the bank network and thus increases the profitability of the existing branch network.
- Client preferences regarding investments are changing. For medium-term and long-term investments there is a trend away from deposits and towards insurance financial instruments and funds where the returns to the client are usually higher.
- In some geographical territories, insurance financial instruments receive favourable tax treatment from their respective governments, and therefore this treatment makes insurance financial instruments more attractive to clients.

There are also advantages to the client:

- The client enjoys greater access to a wider range of banking and insurance financial instruments and services.

- The client generally will benefit from a lower-priced range of insurance financial instruments compared to the more costly forms of product distribution.
- The client benefits from a closer relationship with the bank and there is a better synergy between the client's need and the solution provided by the bank.

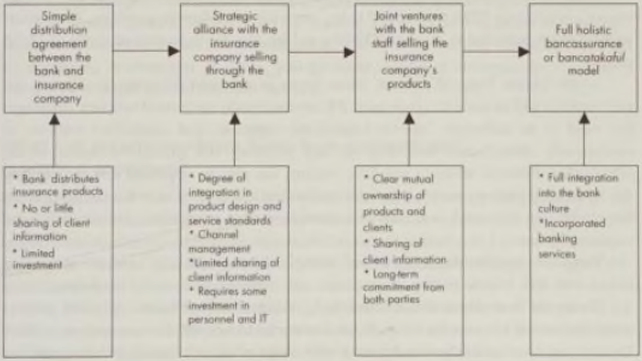
Observers of banca*takaful* suggest that Islamic banks and Islamic insurance companies face a number of distinct challenges:

- the ability to size the volume of business and the complexity of the needs of the clients;
- the opportunity to rebalance financial instruments and services to more closely reflect the changing lifestyle of the clients;
- offering financial instruments and services that compete with conventional bancassurance markets, which have been previously difficult to enter;
- moving from a product-driven to consumer-driven product and service offering; and
- developing banca*takaful* distribution channels that deliver service standards at least on a par with conventional bancassurance.

Client satisfaction is the basic aphorism for bancassurance and banca*takaful*. Institutions must put the client at the very heart of their thinking and development. This means:

Exhibit 8.3

Bancassurance and banca*takaful* structures



Source: Author's own incorporating Tata Consultancy Service (India) and Development Credit Bank Limited (India)

- providing a full range of financial instruments and services through a single distribution network;
- offering high-quality service and advice through highly trained and developed individuals;
- having the ability to meet clients' needs fast and effectively, through the branch, through IT systems, telephone support centres, and continuous internet platforms; and
- having customer services equal to if not better than traditional insurance providers.

Strategic alliances and joint ventures with conventional banks and conventional insurance companies

Much has been written on the issue of Islamic financial institutions forming strategic alliances or joint ventures with conventional financial institutions. The issues vary from region to region and in some cases among *Shari'a* scholars, but generally there is much more convergence today, in turn providing impetus and energy to the Islamic financial services sector.

From an Islamic purist's perspective, to allow a business relationship between an Islamic financial institution and a conventional body could be considered contrary to the valued principles of many Muslims and *Shari'a* scholars. Yet, fostering strategic alliances and joint ventures with the right entities will not only accelerate the development of the Islamic financial sector but will also bring about an ability to formulate and implement new approaches, new technologies and specialisation in new financial instruments. This will pave the way for Islamic institutions to become more competitive with the conventional banking and financial sector, as well as accelerating innovation and development within the Islamic arena.

The Islamic financial services industry is at the threshold of a new level of development. During the last 30 years, the industry has grown by leaps and bounds, from very few Islamic financial institutions (IFIs) to over 200 today, covering more than 48 countries. Total assets worldwide are estimated to exceed US$200bn and are growing at an estimated rate of 12–15 per cent.[3]

As the Islamic financial services sector advances, the need for strategic alliances and joint ventures will increase in significance. IFIs are continually confronted with new challenges that need to be addressed. Islamic institutional capacities and capabilities need to be continuously strengthened, including the key priorities and strategic direction of the organisation. Strategic alliances and joint ventures can play an important role in achieving this by creating greater synergy, which will reduce barriers to entry as well as bringing about faster access to areas such as consumer awareness, market penetration, product design and customer service.

There are examples that a number of strategic alliances and joint ventures are gaining favour with both Islamic insurance companies and conventional financial institutions.

During the first quarter of 2006, Solidarity, a Bahrain-based Islamic financial services group, announced a joint venture with MAA Assurance in Malaysia. The new company, MAA Takaful, has been established to deliver a wide range of Islamic financial instruments and services to the Muslim community in Asia. In recent years, Malaysia in particular has witnessed a tremendous upturn in Islamic banking and financial services. The joint venture between Solidarity and MAA will allow both parties to mutually benefit in terms of technology, consumer

product offering and market distribution. The positive growth of Islamic financial services in Asia is not limited to Malaysia. Significantly, other Asia-Pacific countries such as Indonesia are also moving towards a preferred Islamic financial services sector.

Solidarity also announced recently a strategic alliance with Doha Insurance, Qatar to establish a new organisation that will be known as Doha Solidarity. The new organisation will deliver *Shari'a* compliant financial instruments to the local Muslim market while Doha Insurance will continue to deliver conventional financial instruments. Solidarity is currently planning a number of other strategic alliances and joint ventures with a wide range of Islamic and conventional financial organisations across the Middle East, including banks, insurance brokers and other insurance companies.

The United Arab Emirates has also witnessed conventional financial institutions developing Islamic solutions for the consumer market. Abu Dhabi Commercial Bank, a conventional bank, has recently launched a range of *Shari'a* compliant financial instruments, including the ADCB Meethaq Takaful and Saving Programme. In contrast, Dubai Islamic Bank, established in 1975 as the first Islamic Bank in the United Arab Emirates, has been marketing *Shari'a*-compliant financial instruments and services for many years.

In the Kingdom of Saudi Arabia, a joint venture between the Saudi British Bank and the international banking group HSBC has witnessed the formation of SABB Takaful Company. This new company will develop a range of family and general *takaful* products that are designed to be distributed through the banking network offered by SABB and the wider distribution opportunities offered by the single largest Muslim community in the Middle East.

Small Islamic financial institutions need to merge to form larger, more competitive business units. The industry is dominated by too many small institutions – consolidation and convergence is required so that the Islamic financial sector can continue to grow and prosper. The sector needs larger financial firms that can compete successfully and handle larger projects.

The Islamic financial sector is seeing some convergence of regulatory and auditing standards, and this needs to continue expanding. The industry has also recognised the need for continuing development of stable, well-governed regulatory environments to ensure a sound future for the Islamic financial industry.

What can *takaful* providers learn from conventional insurance providers?

The first decade of this millennium has become one of the most dynamic periods in the development of the financial sector. Financial structures have become increasingly diversified, and there has been increased institutional consolidation, rationalisation and greater international integration. Financial infrastructures have evolved with fundamental changes to support this transformation.

The challenges of intensified competitive pressures have brought about changes in the financial environment; technological advancements, financial reforms and the entry of new institutions into the financial sector continue to test market standards. Consumers are increasingly confronted with a wide range of new and innovative products and services that are delivered via new and more efficient delivery channels. Financial institutions need to anticipate and rapidly respond to these demands and expectations.

The emergence of new delivery channels such as the internet has significantly altered traditional consumer relationships. Business can now be conducted seamlessly across market types and territories. Market leaders can capitalise on these developments in providing new products and services to increasing consumer demand.

The process of convergence within the conventional financial sector has been shaping the global financial industry over the past two decades in a powerful and broad manner. The drivers of this convergence are such phenomena as regulation, financial liberalisation, technological advances in elaborating and disseminating information, and breakthroughs in risk management and in pricing complex financial instruments. These inevitable forces of convergence have been an influence across financial institutions and national jurisdictions.

The Islamic financial sector has begun to leverage on the competitive advantage of the concept of profit and risk sharing. The Islamic financial concept is being more keenly adopted in profit and risk venture, Islamic financial services activities, *takaful* and Islamic wealth management. Providers of Islamic *Shari'a* compliant financial instruments are comparatively new, with the first *takaful* company established in Sudan in 1979. Since that time, while the Islamic sector has been establishing itself and finding its way, the conventional financial sector has been challenged on many fronts and witnessed convergence in many areas.

To move ahead in what is an increasingly competitive and dynamic insurance sector, *takaful* providers need to understand and react to the challenges that lie ahead. One way to achieve this is to analyse and fully understand the challenges faced by the conventional insurance sector, which has been operational for many more years. *Takaful* providers will be more able to adapt and effectively engage in their strategic planning objectives and shift to a new paradigm of success.

A recent pan-European survey of 500 CEOs, carried out by a group of international management consultants and actuaries, identified three significant strategic challenges for the European insurance sector.[4] Distribution effectiveness, changing markets/consumer need, and information and technology management were established as the main challenges. As a result of these findings, 40 per cent of the CEOs surveyed are looking to develop alternative distribution channels, improving service to their internal and external clients and implementing effective use of technology.

The European conventional insurance sector is preoccupied with the need to open more channels of consumer distribution and is looking at IT to solve this issue. Many conventional insurance providers are looking at a multi-channel, multi-provider product offer; while only few conventional insurance companies are strategically planning for a specific consumer niche market product or service solution.

CEOs in the survey concluded that competent advice and planning will become increasingly important as a way of acquiring and developing consumers and an integrated approach to client development will grow at a faster pace. Brand name will continue to be crucial for insurance providers and in the consumer's mind it will prove a vital element in client acquisition and client retention.

The internet will become increasingly useful as a channel for information and administration, while a significant number of CEOs in the survey felt interest would grow as a distribution channel for simple insurance products over time. The internet is still considered by many to be unsuitable for the distribution of more complex and involved financial instruments.

It is recognised that in Europe the best-positioned conventional insurance companies are those with a multi-channel distribution approach: Allianz, AXA, and ING are a few of the companies which distribute across a broad spectrum of channels and are heavily committed in particular to bancassurance.

In conclusion, more products will be pushed to more consumers through more channels as this is seen as a must-have requirement for successful insurance companies to survive and prosper.

Harnessing a consumer-centric culture within the financial sector must encompass fair and equitable dealings with the consumer to stimulate greater trust and loyalty. Greater attention to excellence in consumer service requires continuous investment in systems and employee development. Harnessing the technology to deliver a distinctive consumer experience that combines convenience and value for money is also an essential part of the process.

Takaful providers are able to view the market from an informed position. To prosper in what is a highly competitive industry sector, *takaful* providers will need to offer a full range of products, competitive pricing with comprehensive features and benefits in addition to a wide and varied distribution channel–strategies that include direct sales, insurance brokers, banks, advertising and the internet. To differentiate their position in the market, *takaful* providers also need to leverage on their core values of sincerity, transparency, mutual cooperation and ethical business practices while at the same time challenge and compete with the conventional insurance providers on equal terms of product offering, pricing, brand reputation and consumer satisfaction.

The evolution of *takaful* in the Kingdom of Saudi Arabia

Conventional insurance has been available in Saudi Arabia for more than 50 years with the concentration mainly within the corporate sector, virtually ignoring insurance provision for individuals due to the population's adherence to Islamic beliefs that traditionally have not encompassed personal insurance. In 1986, the Government of Saudi Arabia approved the first national insurance company, which operated according to the conventional principles of a cooperative insurer. Initially this company provided captive insurance for the Government's own needs, but with increased awareness of personal insurance and the growing needs of the population, the company expanded to meet this demand. Yet, there remain a number of challenges that companies entering the *takaful* market will need to address and overcome if insurers in the Kingdom are to maximise and benefit from the opportunities availed by the large Muslim population within Saudi Arabia.

Companies will have to increase the awareness of *takaful* within the Kingdom:

- companies will need to develop products to match needs rather than forcing needs to match existing products;
- companies must improve the image of insurance companies;
- there must be genuine operations based on Islamic principles; and
- companies will need to work closely and must lobby for the support of the Saudi Arabian Monetary Agency.

All these are needed to strengthen and stabilise the *takaful* industry, a status that is achieved only when the theory of large numbers comes into play. This is absolutely essential, first to uphold the principles of the solidarity that is the principle of *takaful* and insurance; secondly to increase the capacity through reinsurance based on *Shari'a* principles. *Takaful* companies entering the Kingdom need to approach these problems in the most professional manner to provide confidence to the consumer with respect to the genuineness of their products and services. Products and operations need to be built on solid insurance grounds and implemented according to the Islamic *Shari'a* with particular emphasis on the account and investment of the income and outgoings carried out on Islamic principles.

Market opportunities in Saudi Arabia are sizeable. The question is can these be turned into opportunities for *takaful* growth? There is a need to seize these opportunities to create and fund an attractive future for customers and investors. There is a need to rise to the challenge of local and international competition by unleashing the creativity and entrepreneurial energy of the people who share and believe in the Islamic financial system in general, and in *takaful* in particular.

In conclusion, the introduction of *takaful* into the Saudi Arabian market during the last five years is regarded as advancing the principles of cooperative insurance and is becoming more widely accepted due to *takaful*'s adherence to the tenets of *Shari'a* law.

In July 2003, the Saudi Arabian Council of Ministers passed legislation opening the Kingdom's insurance sector to foreign investment. The new laws extend to the formaion and licensing of insurance and reinsurance companies, while placing no restrictions on the foreign ownership of these companies.

Provisions within the new regulation include corporate governance, disclosure of broker commission and investment guidelines, while there are requirements to meet employment levels for Saudi citizens and preferences for Saudi reinsurers. Under the new legislation, reinsurance within the Kingdom will be carried out through registered joint stock companies, with the need for these companies to be formed under the laes of Saudi Arabia. The composition and structure of the companies are also subject to the new rules. The rules include:

- 30 per cent of the employees of the company must be Saudi Arabian by the end of the first year of operation, with the percentage increasing in subsequent years.
- The company board members may not serve on the board of other insurance or reinsurance companies.
- The company must establish an audiot commitee, regulatory compliance department and claims department.
- Internal processes to combat money laundering and procedures to take the appropriate actions.
- Comply with relevent labour laws of the Kingdom as well as reporting, ownership, claims processing, solvency margins, policy pricing and language requirements.
- Companies are required to adopt written investment diversification policies and invest 50 per cent of their total assets in Saudi Riyals and investment outside the Kingdom must not exceed 20 per cent of total investment.[5]

1 Source: www.scor.com/www/fileadmin/uploads/publics/focus%20Bancassurance%20oct%202005%20va.pdf

2 Source: www.scor.com/www/fileadmin/uploads/publics/NT2003_10_en_NTSIDen.pdf

3 Source: www.papers.ssrn.com/sol3/papers.cfm?abstract_id=610268

4 Source: www.prnewswire.co.uk/cgi/news/release?id=23823

5 Source: Leboeuf, Lamb, Greene and MacRae: *Saudi Arabia Launches New Insurance Regulation* (2004)

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The reader may find the following websites of assistance:

www.en.wikipedia.org/wiki/bancassuarnce

www.getyourmoneyworking.com

International Cooperative and Mutual Insurance Federation (www.icmif.org/2k4*takaful*)

The author is also indebted to the following organisations and individuals for their advice:

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Tata Consultancy Service (India).

Chapter 9

Retailing *takaful* products

Ajmal Bhatty
HSBC Amanah

Introduction

Retailing applies to direct-writing *takaful* companies and covers products sold to individuals, groups and companies, both in family *takaful* and general *takaful* (life and general insurance). Retailing encompasses most of the functionalities of product development, marketing (together with sales) and the subsequent management of the business. Retailing any financial product is a vast subject and we can here only scratch the surface in this chapter.

Retailing begins with getting to 'know' what the customer wants, and then effectively delivering and servicing the 'right' lifecycle products with the relevant need for protection and savings. This is in respect of financial protection of life and assets, as well as saving for cash and/or income to be available when needed, either during one's working life or in retirement.

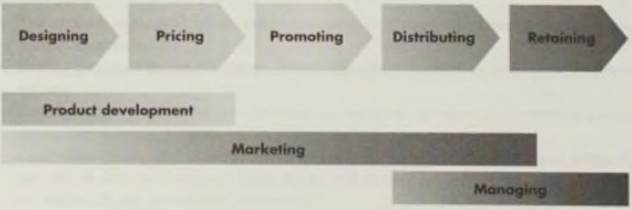
Retailing as part of the business process

Pertinent questions in the retailing process are:

- Who are the customers and how do we reach out to them?
- How do we ensure that the concepts are well understood?

Exhibit 9.1

Retailing *takaful* products



Source: Author's own

- How do we ensure that customers are satisfied?
- How do we ensure that expectations of all the stakeholders are adequately met?

Most of the functions illustrated in Exhibit 9.1 – designing, pricing, promoting, distributing and retaining – are similar between conventional insurance companies and *takaful* companies, but there are subtle differences in almost all of these areas to ensure the *Shari'a* authenticity of the product.

Shari'a authenticity

In most markets, customers do not widely understand *takaful* and, where they do, many question if what the industry offers is genuinely *Shari'a* compliant. After the achievements since the 1980s and 1990s in building the infrastructure of *takaful*, the largest challenge (and threat) that we currently face is the lack of *Shari'a* authenticity in the way we build and manage *takaful* funds and operations and deliver products and services. The delivery of products and services in a *Shari'a*-authentic way is the most difficult aspect of this, as it means providing a practical demonstration of meeting customer perceptions about *takaful*. In some markets there may be a general perception that *takaful* provided through an Islamic window by a conventional provider is less authentic than a fully-fledged *takaful* company, even though the window may be more authentic due to its strict adherence to *Shari'a* principles. In some markets, the challenges come from the regulatory aspects within which *takaful* business has to operate. The most damning situation is where a *takaful* company operates entirely for commercial motives rather than respecting and appreciating the reasons for which the *takaful* system was initially developed.

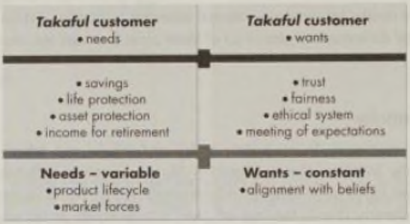
Designing

Designing a product is all about the customer. A product exists to meet the needs and wants of the customer, which accords also with the *Shari'a* principles of serving the customers in fairness to their needs. The process of product design therefore must focus on customers' needs and wants, which are illustrated in Exhibit 9.2. The assessment of 'needs' follows the usual lifecycle approach, matching customer needs at different stages according to the customer segmentation of the available market. These needs continuously change not merely because the stages in the lifecycle alter, but also because of structural changes related to lifestyles and demands, longevity, and other market forces (see Exhibit 9.3).

Customers' 'wants' in the context of *takaful* are expressed in terms of the trust consumers hold towards the *takaful* provider. Customers expect that the concepts and system of *takaful* offered through *takaful* products are built on fairness and that the company's operations, investments and profits are managed and distributed ethically and in a socially-responsible way. These expectations remain constant and the onus is on the *takaful* provider to be fully aligned at all times with these concepts and beliefs. This is one of the most important differentiating factors between a *takaful* and a conventional product. There is a great deal of sensitivity attached to it, in the sense that any weakening or erosion of this trust is likely to have permanent damage to the brand image of the provider.

Exhibit 9.2

A view on the needs and wants of *takaful* customers



Source: Author's own

Exhibit 9.3

Designing and pricing considerations

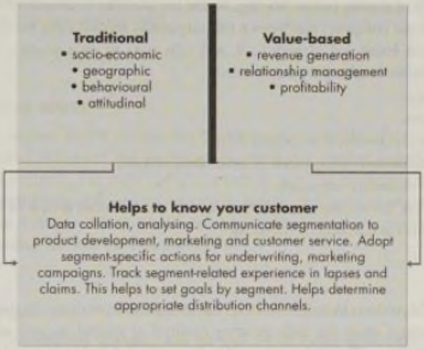
Source: Author's own

Customer segmentation

Customer segmentation is vital to understanding a provider's target customers and is a process that can be completed only when the company knows its market very well. Customer segmentation is necessary in covering both their needs and wants, and should lead to an understanding of the likely behaviour and potential profitability of the business. The process is not easy and involves consumer research studies of qualitative and quantitative natures that focus on profiling customers by age, gender, location, profession, education standards,

Exhibit 9.4

Customer segmentation



Source: Author's own

propensity to save or spend, perceptions and awareness of financial products such as *takaful*, and the like. The process would analyse revenue generation by different groups of customers, as well as the costs of establishing and maintaining relationships with them. Exhibit 9.4 provides an illustration of the issues to consider in customer segmentation.

Pricing

Shari'a authenticity of a *takaful* offering is important, but equally so is its competitiveness. Customers are likely to know the price of conventional products that are in the market. An expensive but very 'authentic' *takaful* product is unlikely to sell well. On the contrary, many customers may believe that since the products are based on *Shari'a* principles, these ought to be cheaper – a misconception that needs to be corrected through training and promotional campaigns. Pricing experts view the profit-sharing aspects of *takaful* to be something that should be built into the margins. This revolves around the finer balance that needs to be achieved between return on capital and competitiveness. The essence of *takaful* requires that the product should be competitive, non-exploitative and fair to all parties. If the premium is the source of surplus then that surplus ought to be shared. The company is paid for its technical expertise through management expenses and 'no claim' discounts are a function of underwriting experience. The remainder, after claims and reserves, belongs to the remaining fiduciary stakeholders (customers and shareholders). The different ways of apportioning expenses and

allowing surplus between *takaful* customers and shareholders (wakaful, mudaraba, waqf models) is outside the scope of this chapter.

Pricing considerations run along the following lines:

- manufacturing or renting (white labeling, where the provider (a distributor such as a bank or another *takaful* company) purchases a fully-supported product from another source, then applies its own brand and identity to it, and sells it as its own product. The purchaser assumes the seller is selling its own product);
- competitiveness;
- cost efficiencies;
- market forces (as described in Exhibit 9.3);
- the cost of capital and future trends in investment returns;
- mortality and morbidity rates; and
- how realistic are the assumptions (checked against a continuous review of assumptions of existing business and stochastic modeling).

Promoting

Promoting *takaful* products includes branding, marketing and advertising. Strategies are needed to educate customers about the differentiating qualities of *takaful*, as well as the product's most important features. The customers need to be persuaded first to buy and then be shown ways to enhance their satisfaction with the purchase.

Consumer awareness and education

Takaful is about mutual help between participants of a *takaful* scheme, which is an extension of a seamless social welfare order. Protection through insurance has a great social value for individuals competing in challenging economic environments. This is true for all times, whether we are talking of year 2000 before Hijri or 3000 after Hijri (start of Islamic calendar, AD 622). Yet, insurance has remained an unmentionable topic for hundreds of years amongst Muslims as it is believed to be haram (prohibited). The introduction of *takaful* has changed that for those who know of the system, but many do not. When we talk about insurance in the form of *takaful*, it is no longer a taboo as it is a system to which customers can relate and it falls in line with the customers' values and belief.

An important feature of *takaful* is its ethical nature – not just from the religious point of view. The *takaful* system is a fair system for all, and everyone should be able to benefit from it.

Distributing

If 'designing' is to do with the way the industry thinks about its customers, then 'distribution' is the key to unlocking the door to reach them. The route we take needs to be clear and short to ensure that there is a feel-good factor on both sides. Mis-selling, costly processes, and a high cost of business acquisition can ruin future prospects of building a durable and profitable proposition for customers and shareholders alike.

All types of distribution channels are used for *takaful* sales, such as:

- branch network (employed and/or commission-based agency salesforce);
- direct selling (call centres, internet and telemarketing);
- bancassurance or banca*takaful*; and
- brokers.

Agency/broker sales

Sales through salaried and/or commission-based agencies provides direct control over the business generated. Managed and controlled properly, this channel has the greatest value addition to the business. For more complex products, agency and broker sales may be the best route. Unfortunately, this route is not easy to manage and costs can escalate. Mis-selling can easily occur if certain income targets are to be met in a week or a month, irrespective of whether the product has met the customer need.

Direct selling

Technology is continuously changing and the way we do things must therefore change with it. Customer expectations remain the same, however – the desire for better service and value-for-money products. Direct selling can be an excellent medium to achieve this.

Direct selling through the electronic medium may be useful to:

- increase business volumes;
- access customers who are costly or difficult to access through traditional channels;
- help reacting to or be proactive in response to competition; or
- gain economies of scale on costs in relation to turnover.

The internet provides an excellent platform, not only to generate business but also to help customers' understanding about the *takaful* concepts and system. Knowledge of consumer habits in the usage of the internet is important in adopting this route. *Takaful* customers are increasingly a part of a growing number in the educated Muslim middle class. They create the impetus in financial markets through their ability to save and spend. They are becoming increasingly aware of the Islamic socio-economic order that can be the basis for a just society in accordance with the principles of Islamic *Shari'a*. Islamic insurance, like Islamic banking, offers exactly that . . . ethical forms of business dealings, based on principles that are good for society as a whole.

The electronic medium enables us to reach out to millions in seconds.

- There were approximately 160 million sessions per month on HSBC websites during 2006.
- There were 300 million internet users in the world in 2000. This grew by more than 3 times to c1.09 billion by the end of 2006 (16.6 per cent penetration of world population of 6.6 billion people).

In adopting an internet selling strategy, *takaful* companies need to know:

- who are the internet users in their particular market;
- what is the best way of reaching them (through their own website or third party portals); and
- what product and service would be most appealing to them.

Internet users tend to have the following characteristics. They are:

- above-average earners;
- well informed;
- price conscious; and
- generally like several quotes to compare.

The most voluminous internet sales have been in books and CD roms, software and hardware, toys and gifts, and travel and on-line stock trading. This is because these products have the following characteristics:

- they are standard products;
- no detailed explanation is needed;
- completion of the transaction is quick and simple; and
- prices are comparatively low (except for stock trading).

Do *takaful* (insurance) products have such characteristics? Can we devise products and their delivery to fit these characteristics?

Exhibit 9.5 illustrates how the suitability of *takaful* products is directly linked to simplicity of products to the internet user.

The most popular e-*takaful* products for internet sales are those that are easily explained and understood, such as motor, personal accident (PA), household (buildings and contents), travel, MRTA (mortgage protection) and term life. These products usually require a minimum of advice.

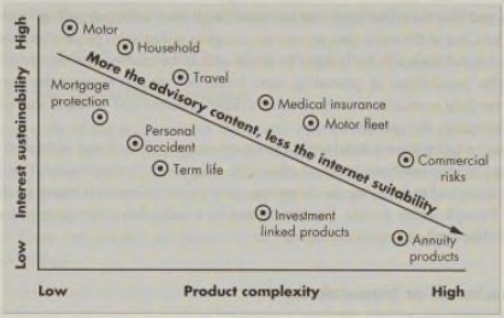
The internet user surfs usually in a passive sales medium of websites and portals. The provider of goods and services therefore must devise ways of indirectly attracting a steady stream of visitors to its site. This is not easy with insurance products, as insurance is traditionally 'sold' rather than 'bought'.

Takaful companies would normally operate their own websites, but achieving success in selling through the internet requires a high degree of resource and capital commitment. A cost-benefit analysis must be carried out and alternative internet solutions must also be considered such as going through:

- product portals;
- internet brokers; and
- point-of-sale-based internet marketing.

Exhibit 9.5

Sale of *takaful* products through the internet



Source: Author's own

The latter entails targeting one's *takaful* products at potential clients by linking them to certain themes and events, for example, car loans and sales, real estate sales, or web-based themes of 'starting college', 'career change', 'weddings', 'parenthood' or 'retirement'.

Branding an e-*takaful* product means that the company should be able to deliver a value-for-money proposition with utmost ease to the customer. The service should be reflective of the efficiencies normally associated with the electronic medium – that it is fast and simple. This involves considerable administration capability and systems capacity to handle the volumes that are likely to be far greater than those to which the company is used through other means of distribution. If the company fails to deliver this, the internet experiment for the company could become a nightmare and the branding could be damaged irreparably.

Consider a successful company that employs a direct salesforce, has 10,000 clients and handles 100,000 transactions every month. It decides to go e-*takaful*. It spends the required amount of money and does all the right things to generate successful internet sales. The result is a resounding success generating an additional 100,000 clients in the first quarter requiring 1,000,000 transactions to be processed each month. Can it handle this kind of volume of transactions and still deliver quality service? Or should it aim for achieving economies of scale in areas it can handle best and outsource the rest by deconstructing its value chain? This way, its ROE can remain intact and even improve.

Insurance protection does not feature in our every-day thought process, even when we know that we need it. Visiting the website of an insurance company is not a regular occurrence or an enticing prospect compared to the need to look for a car, cheap travel or regular on-line banking. Therefore, tying e-*takaful* to a popular portal or search engine is a must.

The end game is to build a brand name that becomes a byword for the company's *takaful* products on the internet. This should result in repeat visits, increasing the chances of turning visits into sales. When the user is online, he or she needs to be engaged in an entertaining manner. These visits are windows of opportunity with a timespan of seconds. You need to grab them and turn them into leads and referrals. There must exist compelling reasons for the visitor to buy, but at the same time an easy-to-complete online sales process to close the sale.

An e-*takaful* approach for *takaful* products should be encouraged not only because it increases the possibilities of generating more business, but also because the internet is an excellent medium to maximise awareness of *takaful* concepts and products that are still not well understood by the masses.

To brand an effective e-*takaful* product one must understand the basics of internet marketing – knowing your customer and having a glitch-free technology in your market. One must have simple products and an engaging and interesting sales process. One must ensure quality service delivered through secure portals. Finally, it must be a value-for-money proposition for both the shareholders and policyholders alike.

Bancassurance or banca*takaful*

There are a great many potential customers for *takaful* products who are bankable customers. Insurance, as we know, is a hard sell, and what better alternative platform to approach these customers from than their own bank. Bancassurance or banca*takaful* is a win-win proposition for everyone: the customer, the bank, the *takaful* provider and the regulator. The comparative perspectives are as follows.

From the bank's perspective:

- brand name recognition;
- a relationship of trust with the customer, which is very important in relation to long-term contracts;
- better customer profiling driven by a lifecycle approach and powerful credit-driven needs;
- owner of a large proprietary database covering all types of customer segments (retail, small and medium-sized enterprises (SMEs), corporates, high net-worth individuals (HNWIs), trust services, mutual funds, stock broking, credit cards, e-banking);
- wider customer access through large branch networks;
- helps the bank to sell more of its own products;
- enables access to funds that otherwise remain with life *takaful* providers; and
- risk-free income from commissions and fees that is stable and reduces the need for risk-based capital for the same level of revenue.

From the perspective of the *takaful* provider:

- focused product manufacturing and underwriting;
- relevant insurance sales culture (different and more aggressive than the bank);
- reduces reliance on traditional agency channels;

- gives access to tap into the bank's huge customer base (HNWIs, and the like, as above);
- build market presence rapidly (in developed markets such as France and Spain around 60 per cent of new business policies comes through bancassurance);
- the cost of distribution is much lower (if the direct sales cost of distribution is 70 per cent to 80 per cent, then a similar cost through bancassurance could be some 30 per cent to 40 per cent); and
- access to established bank systems for collections, payrolls and delivery.

The approach also has benefits for customers:

- Large segments of the population in the lower- and middle-income groups are usually poorly served by insurance companies' sales agents who tend to aim for higher-income individuals paying higher premiums to compensate for low-volume productivity. These customer segments are therefore better served for *takaful* needs through bancassurance;
- Customers get products more suited to their needs; and
- Some of these cost savings are passed on to the customers, making the products better value for money.

There are several ways in which customers consider when spending money, and many other priorities before people begin to think of insurance. Customers tend to only reluctantly allow insurance sales agents to talk to them, and tend to visit insurance companies rarely. Yet most of the population particularly in the West has been long exposed to banking products, loans, mortgages, credit cards, and the like. Customers are therefore on more familiar ground when a bank seeks to provide them with an insurance or *takaful* solution while they are at the ATM drawing some cash, or when online. The premium can be deducted directly from the customer's account and appear in their bank statement. Both the quantity and quality of *takaful* business can improve through bancassurance.

In 2006, the *takaful* scene is painted with:

- considerable potential;
- increasing numbers of *takaful* providers;
- a better range of investments; and
- a tangible growth of *takaful*.

The time is therefore ripe for *takaful* companies to become active in the long-term business, yet it is not easy to develop direct sales and build a quality business within a short space of time. Distributing *takaful* through banks enables this to occur. Bancassurance should be particularly attractive for the *takaful* industry for a number of reasons.

- Most *takaful* companies are either new or do not have a large agency workforce. It would be better for them to start from a distribution channel that is easier to manage and more cost effective (that is, bancassurance).
- Customers visit banks generally frequently. Customers have been long exposed to banking products, loans, mortgages, credit cards, and the like. Going to a bank is a familiar territory. It may seem easier when a bank provides us with an insurance or *takaful* solution because of convenience.

- Through bancassurance, *takaful* companies can reach out to customers that they may not be able to on their own, with relative ease. Mass marketing is easier provided bancassurance products are simple, easily available and inexpensive. For more complex products such as savings, education and retirement, the sales process becomes more involved, requiring more disclosure and face-to-face contact with an insurance / *takaful* sales person.

For bancassurance to take off in markets where *takaful* is in demand, certain prerequisites are essential.

- A conducive regulatory environment allowing banks and *takaful* companies to form distribution alliances. The ultimate beneficiary would be the customer.
- Statutory *takaful* supervision in ensuring solvency and long-term durability of *takaful* businesses.
- Secure and rated *takaful* companies, especially in the case of long-term business. This is essential to ensure confidence in meeting long-term financial commitments with good service, the ability to pay claims and meet customer expectations. Banks have their reputational risk to protect and their risk-free income can be damaged if the *takaful* company defaults in the long run.
- A dedicated staff well trained in *takaful* concepts and product features.

Retaining

There is considerable effort and energy expended on finding new customers. Once they become 'existing customers' they are (or should be) considered as gold dust. The beauty of *takaful* (or insurance) products is that a great deal of cross-sell and up-sell can take place from one sale. A motor customer can buy travel, personal accident, household, mortgage protection, investment-linked savings, an education plan, or a retirement plan. A similar cross-sell between *takaful* and bank products can generate huge amounts of additional business and sources of revenue.

To make this possible, business analysts should continuously build and update customer profiling, and the IT system should enable easy and fast access to it. This should help provide a clear view of customer preferences and behaviour. The key is ready and fast access. Other areas that help to retain business are training, maintaining high standards of service, and ensuring that best practices are properly understood and implemented. A feature that is unique to multinational companies is the portability of products to different locations that help to continue with premium payments and receipt of benefits as and when they fall due.

Training is also an important aspect. *Takaful* companies need to achieve a good balance between insurance expertise and *takaful* know-how. The natural source for this talent is the insurance industry itself, but there must be a precise understanding of how the insurance expertise and knowledge is applied within the boundaries of *takaful* rules and processes. The technical aspects can be handled easily. It is the practical aspects of *Shari'a* authenticity that remain exposed. Experience shows that it is more often the latter aspect that is more difficult for *takaful* operators to manage. This danger is heightened at the time of writing (2006) as

the speed of development of *takaful* has never been greater. This hive of activity, where new companies and windows are mushrooming at great speed, has the potential of building *takaful* rules and processes with a bias towards insurance rather than *takaful*. The industry may succeed in attracting a lot of business for a few years, but if its systems are shortcuts and compromises on aspects of *Shari'a* principles, this will soon enough become apparent and the business may wither away with dire consequences for the shareholders and the industry alike.

The role of the international banks

The international banks can play an important role in boosting the growth of *takaful* through reaching out to the customer, either as an effective channel of distribution or directly in manufacturing and distributing. In some cases, the banks may be reluctant to white label third party products as this may carry reputational risk if the *takaful* provider is small, with a limited product range, unrated security, or inadequate resourcing. Multinational *takaful* companies do not currently exist, and of the few large *takaful* companies, most are still local or regional. International banks can open up a great many avenues, as there are dimensions that are reached only when institutions go big and are able to benefit from economies of scale. These dimensions are as follows.

1. Economies of scale.
   - International banks have a wealth of resource in talent, skill sets and technology. This provides help and support as and when needed at regional and local levels, resulting in a small number of regional back offices serving a great number of local businesses.
   - Scale allows better standardisation of processes and services in building and maintaining high quality. This includes efficient call centres, e-business and cost-effective delivery channels.
   - Multi-geography presence facilitates the portability of benefits as customers move from one country to another.
   - Best practices are exportable from one market to another with relative ease, providing first-mover advantage over the competition. This can also result in entry barriers for the competition.
   - The game of large numbers is played better, both in terms of business volumes and funds under management. This can result in more direct management and greater savings on volumes.

2. Consumer Confidence.
   - Established processes and systems, a trained work force and well-capitalised operations provide the basis for secure, durable and well-rated operations. This is essential to give confidence to regulators and customers, especially in the case of long-term business.

Currently there is only one international bank (HSBC) with ownership of fully-fledged *takaful* companies and windows providing customers with quality service and business durability in a manner that becomes a good value proposition for them.

Conclusion

In retailing *takaful*, the message must be clear that *takaful* has to do with fulfilling the perceptions of customers looking for Islamic solutions. Insurance is interesting to them when they see it through the filters of *takaful*, as it provides an ethical and fair system. This is especially so in the case of personal insurance such as family *takaful*. These perceptions of an ethical and fair system go beyond serving the Muslim customer, as these are built around the idea that what is good for individuals is good for the community and for society at large. A universal recognition of this fact leads to credible institutions that provide consumer confidence and bring benefits to the society in which we live, wherever on the globe that may be.

Further reading

1 'Branding an e-*Takaful* product', Ajmal Bhatty, 2005.

2 'Shifting *Takaful* into Higher Gear', Ajmal Bhatty, 2006.

3 These papers are available from this author, email: ajmalbhatty@hotmail.co.uk

Chapter 10

Marketing financial services

Bassel Hanbali
Solidarity

Introduction

Islamic financial services, mainly *takaful* (Islamic insurance), is being recognised by the world's financial industry for its market-driven initiatives, credibility and strategic growth. There is a great awareness of the need for insurance combined with religious and cultural resistance towards conventional insurance, that makes *takaful* the preferred insurance option. Some *takaful* markets are more developed than others, however in general, the development of this expanding and unique Islamic system of insurance and assurance offers over one billion Muslims the opportunity to help plan for their financial future.

As defined by *Shari'a* scholars, the principle of *takaful* is to provide protection to those individuals who need it most, a principle in line with the fundamental tenets of Islam. The concept is built on the principles of compensation and shared responsibilities among the community to provide quality of life for all, and to uphold the dignity of individuals, families and society in general.

To take advantage of this positive climate, *takaful* providers need to approach the market in the most professional manner. They need to communicate with the public, end-users and institutions both governmental and commercial, to deliver a common message which is that 'individuals need to personally plan for and manage their financial destinies utilising methods that comply with the principles of the *Shari'a*'.

The *takaful* products supplied, the distribution channels employed and the *Shari'a* rules and legal regulations that must be adhered to must be communicated and understood by everyone in the *takaful* chain. If financial professionals do not employ the appropriate communication tools and work together, they will not be able to produce the social and economic benefits that they seek.

Designing innovative and competitive products alone is not the answer. Manufacturers and distributors of these products must remember that 'financial products, especially insurance, are sold and not bought'. This means that they have to communicate the right message to educate the market and help in providing individual client awareness of the critical need for individual financial planning.

An overview of financial services marketing

The flourishing of financial services marketing has presented a new challenge to most business organisations distributing Islamic products, especially financial services institutions. The

challenge is not only how to catch up with the rapid pace of marketing evolution, but more importantly, how to strategically use it to communicate within a competitive financial environment where everybody has equal opportunities.

Marketing enables financial services institutions to stand out of the crowd of competition on the global network by sharing their distinctive advantages. However, there are remarkably few publications on the effective and efficient use of marketing and its influence on financial services products' sales volume. This chapter examines the needs and means by which *takaful* providers can utilise marketing strategies to identify the step-by-step development of a unified communication theme.

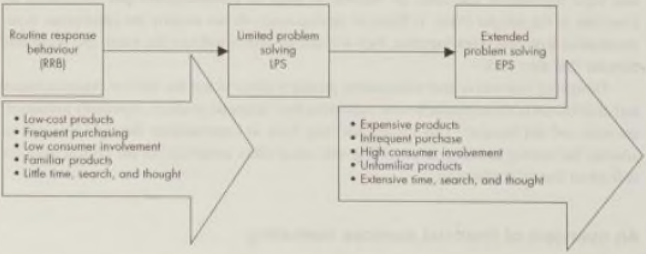
Consumer behaviour

The development of *takaful* from the early 1970s has attracted a growing interest in the financial services industry as it brings fundamental changes to the way of doing business and sets new standards for future insurance and assurance operations.

Takaful, either family (life) or general (non-life), has received a great deal of attention from financial professionals, especially for offering an additional product line or extension to a wide target market. Many financial services firms have set up a company, branch, or window that provides *Shari'a* compliant products. Organisations are rushing to design innovative and competitive products, building solid operational infrastructure and signing strategic alliances. They are quickly moving to begin operations, postponing studying the effect of their new offerings on the targeted market. Marketers with appropriate marketing direction play a major role and can have a remarkable impact on the launch, growth, and development of *takaful* products. They can capitalise on the abundant opportunities of their offerings and gain substantial competitive advantage by creating a positive customer attitude. Therefore, implementing a coherent marketing approach should include researching and

Exhibit 10.1

***Takaful* customer decision-making types**



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understanding of customer needs and expectations to broaden and deepen the customer base and retain individuals as customers. Studying consumer decision-making types (see Exhibit 10.1) and the level of their involvement helps understand their buying behaviour, which in turn leads to an effective and efficient formulation of marketing strategies and tactics.

It is crucial to identify the customer-involvement process as it is one of the most relevant influences in the buying behaviour. It refers to a customer's degree of interest while searching for a product or service. Consumers interested in *takaful* products, especially family *takaful*, are highly involved as they search for more information (external and internal) through different criteria before they make any decision. They act to minimise the risks and to maximise the benefits obtained from purchase and use.

In fact, when high-involvement decision-making is present, buyers perceive a high level of risk and are concerned about the intended purchase.

After studying the type of *takaful* customer decision-making types and their level of involvement, it is important to understand the nature of their buying behaviour. The latter

Exhibit 10.2

***Takaful* customer-involvement process**

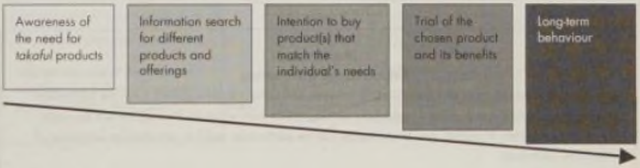

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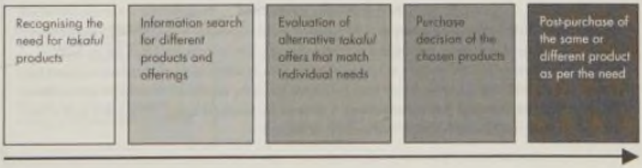
Exhibit 10.3

***Takaful* customer buying process**



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involves identifying and understanding the needs and motivations of existing clients and potential customers, as well as how they go about making buying decisions (see Exhibit 10.3).

The model of a *takaful* customer buying process is based on the assumption that *takaful* buyers will pass through a cognitive, effective and behavioural stage. Exhibit 10.4 examines

Exhibit 10.4

Traditional consumer buying behaviour model

Stage one

Pre-purchase information search

1 engage in pre-purchase trial of a simple *takaful* product to observe its characteristics and qualities;
2 rely on the experience of others who have already used such *takaful* offerings; or
3 scan the offers within the market.

Stage two

Evaluation of alternatives

The information search leads to the comparison between alternative *takaful* suppliers. From the information gathered, a customer can develop a preliminary set of products from which the final choice will be made. The physical facilities, branding, and brand loyalty can be particularly useful in providing an indication of alternative evaluation.

Stage three

Post-purchase evaluation

The evaluation of alternatives is necessary to build experience and knowledge aiming to fulfil predetermined needs. The process of evaluation, with respect to *takaful* offerings, is more complex due to the products' technical specifications and the medium- to long-term involvement. In addition, *takaful* products represent new entrants to the market and customers do not have the knowledge or the experience to compare and evaluate what they received. Therefore, they are more likely to focus on the functional quality of the offers such as the services provided, operational flexibility, and empathy of the staff.

Source: Author's own

the traditional consumer buying behaviour model in a simplified version which breaks down the process into three stages.

In fact, recent economic, social and technological trends have had an impact on customers' demand for financial services products. Such trends indicate the importance of getting to know the consumer and understanding what influences purchase decisions. In order to understand what purchase motivations *takaful* customers require, marketers within financial institutions have to identify the relationship between their products and the needs within the targeted groups, especially focusing on the buying behaviour, involvement level and type of decision-making.

In addition to customers' buying behaviour, the marketing department is responsible for transferring the picture of the competitive environment including internal factors (strengths and weaknesses) and external factors (opportunities and threats). Exhibits 10.5 and 10.6 illustrate this. The reason for such analysis is that it will support the management to link the overall business scope and the marketing direction applied to achieve corporate goals.

Exhibit 10.5

An external analysis of the competitive environment

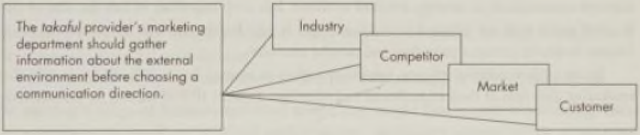

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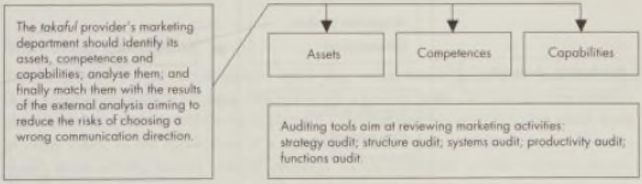
Exhibit 10.6

An internal analysis of the competitive environment



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Other auditing tools can be implemented by *takaful* companies to provide maximum information and analysis on the existing situation. This in turn will help identify the firm's marketing direction. Auditing tools include: value chain analysis; *takaful* product lifecycle; experience cure; gap analysis; and SWOT analysis.

Marketing strategy

Exhibit 10.7 represents the *takaful* provider's market direction by identifying the source of its competitive edge according to its targeted segment.

When designing the *takaful* firm's scope of business, management teams within *takaful* companies have to identify their communication approach in the market. For instance, if they are looking to achieve superior performance of their services, quality, or technology, then their communication choice should be based upon applying a differentiation focus marketing strategy. On the other hand, if top management within the *takaful* firm is aiming to achieve the lowest costs, to provide cost-effective *takaful* products priced lower than competitors, then their communication choice should be directed towards a cost-leadership focused marketing strategy aimed at winning a large market share within the targeted market.

Whatever the business scope of the *takaful* provider, management should focus on one or more narrow market segments, get to know these segments intimately, and pursue the relevant communication strategy referred to above. It is very important to link the size of the targeted group with the selected strategy, and that is why Exhibit 10.7 differentiates between Islamic financial services providers and *takaful* providers.

Being in their relative infancy, *takaful* providers in general find it difficult to identify the marketing direction of their name/brand and offerings. Exhibit 10.8 illustrates an inconsistent

Exhibit 10.7

***Takaful* marketing strategies**

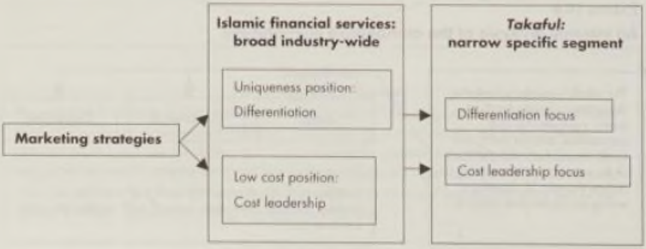

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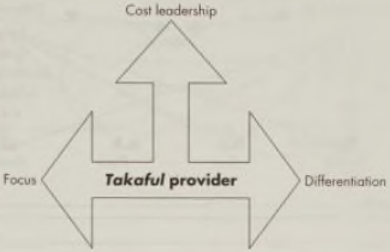
Exhibit 10.8
Inconsistent marketing directions



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marketing direction for *takaful* providers, where they are not able to position themselves in this dynamic financial marketplace.

The solution to the inconsistent marketing direction strategy is through identifying:

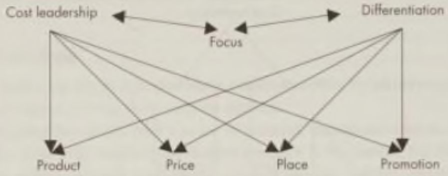
- the firm's scope of business and what tactics they would like to choose (defending their existing market position; attacking market leaders; duplicating existing offers; or focusing on a niche market within the targeted group); and
- the product/market tactics aimed at comparing different options that enable them to grow (penetrating existing markets with the same offerings; developing new markets by providing the same offerings; developing new offerings for existing markets; or diversifying itself by entering new markets with new offerings). Strategic alliances, especially in the *takaful* industry, play a major role in supporting the *takaful* provider while choosing the right option.

Marketing mix (tools)

Takaful providers must decide on how much they would like to adapt their business scope in different markets while targeting different group segments. In the financial services industry, providers need to decide whether to implement a standardised business direction which leads, in many cases, to the application of a standardised communication flow. Other providers, mainly those offering Islamic (*takaful*) products, should build their business scope on the fact that they adapt their offerings to match individual and market needs. Hence, their communication flow should match the religious/cultural boundaries of each market.

Exhibit 10.9

Marketing strategy and marketing mix



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Marketing communications

Marketing communications for *takaful* products represent the design and distribution of information about different *takaful* offerings to satisfy different customers' needs. With the developments of marketing communications management, the financial services provider is entering an era of direct information flow with the target markets where they are creating messages and utilising media to attract customers and reinforce product education.

The department responsible for marketing Islamic financial products, especially Islamic insurance and assurance, should understand the role that marketing communications play in positioning its offerings in the minds of customers. Furthermore, it has to form the link between the selected marketing communications strategy and the customer-buying behaviour process discussed above.

Marketing communications facilitate exchange between individuals, groups or other organisations. At a basic level, marketing communications can inform and make potential customers aware of *takaful* offerings, and persuade current and potential customers of the desirability of entering into an exchange relationship. Finally, marketing communications can act as a differentiator, particularly in the financial services industry, where there is little to distinguish between competing offerings. This is illustrated in Exhibit 10.10.

The objectives of marketing communications are derived from understanding the overall context of the core business of the *takaful* firm. In fact, there are three main streams of objectives that *takaful* providers should identify:

- issues related to the targeted group and *takaful* products offered;
- issues related to market share, sales volume, profitability and revenue; and
- issues related to the image, reputation, and preferences of the *takaful* provider.

Exhibit 10.11 presents the flow of objectives while formulating the marketing communications plan.

Exhibit 10.10

The role of marketing communications

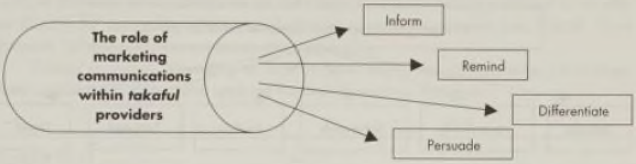

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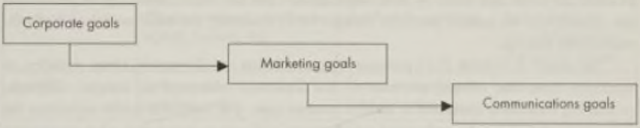
Exhibit 10.11

Marketing communications' objectives



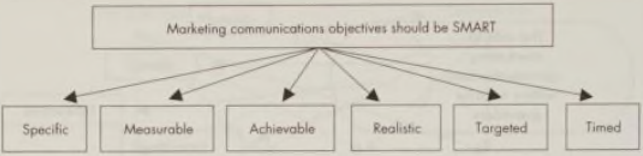
Source: Author's own

The marketing communications brief, which is derived from the accurate market analysis of the *takaful* provider, specifies sales and customer-related objectives as the following:

- create awareness by ensuring that customers know who the provider is and what are the *takaful* offers provided;
- educate and inform the market about the importance of *takaful* in general and the importance of each product in particular;
- increase the rate of purchase of existing clients through designing loyalty programmes;
- increase market share by targeting and attracting current non-users;
- improve brand and product recognition and acceptance; and
- create an atmosphere favourable for future sales through relationship building.

When setting the marketing communications' objectives, marketers need to draft specific, measurable, achievable, realistic, targeted and timed objectives. The process of making these objectives 'SMART' requires management to consider exactly what is to be achieved, when, where, and with which audience (see Exhibit 10.12).

Exhibit 10.12
SMART objectives



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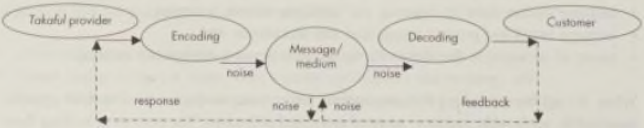
When implementing marketing communications, a *takaful* provider attempts to create and sustain a dialogue with its various constituencies. In other words, *takaful* providers have to know the needs and wants of their target market, and the target market has to understand the offerings of the *takaful* provider. Exhibit 10.13 illustrates the basic model of the communication process.

The model in Exhibit 10.13 presents the transmission of information, ideas, attitudes, or emotions from the *takaful* provider to the customer interested in *takaful* offerings, or existing customers interested in another product type. The *takaful* provider represents the source/sender that has to understand which target audience to reach and what response it wants. Therefore, the source has to transmit the message through effective and efficient medium, such as advertising or public relations, that will reach the customer or potential customer (technically named as receiver) and create a feedback channel to monitor the receiver's response to this message.

Exhibit 10.13
A basic model of the communication process



Source: Author's own

The marketing communications strategy

The marketing communications strategy is the combination of activities that concerns the overall direction of the *takaful* provider in relation to its customers and potential customers. *Takaful* providers should always revisit the *takaful* customer's buying behaviour to be able to identify the appropriate effective and efficient communications direction. Exhibit 10.14 presents the three different communications strategies.

Takaful providers, depending on their business scope, should have always a strategic balance when selecting and/or applying the communications direction.

Exhibit 10.14

Three communications strategies

Communications strategy	*Takaful* customer or potential customer	Objective	Communications direction
Pull	Customers (individual or corporate)	Consume the product / purchase	From *takaful* manufacturer to end-users directly
Push	Channel intermediaries (banks, agents, brokers, etc)	Distribute the products	From *takaful* manufacturer to the distribution channel
Profile	Relevant stakeholders (staff, suppliers, etc)	Strengthen image and build reputation	Interactive

Source: Author's own

Marketing communications mix (tools)

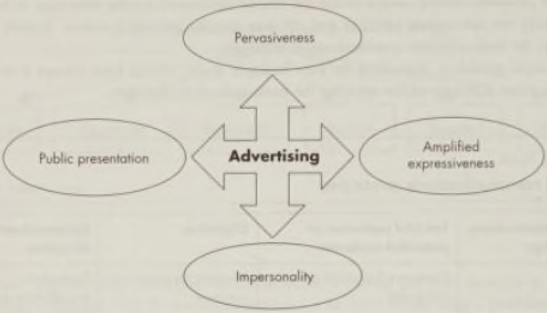
As the above discussion has illustrated, *takaful* providers have to transmit the message through an effective and efficient medium to influence the purchase behaviour of customers. There are several types of methods that can be used to communicate with individuals, groups and/or organisations. Each has its own characteristics and costs depending on the objectives set and current market analysis.

There are six marketing communications tools that can be used in different combinations and to different degrees of intensity, in order to match the products offered with the current market situation, targeted audience and objectives:

- advertising;
- sales promotion;
- public relations;
- sponsorship;
- direct marketing; and
- personal selling.

Exhibit 10.15

The qualities of advertising



Source: Author's own

Advertising plays a major role in influencing audiences by creating cusomer awareness, informing or reminding customers of an existing *takaful* offer through illustrating its benefits in comparison with those of competitors. Exhibit 10.15 illustrates the qualities of advertising.

The main objective of sales promotion is to prompt buyers interested in *takaful* products into action through providing additional value. This tool is used to reach new customers, reward behaviour, increase customer retention and add value. *Takaful* providers benefit from the use of this tool by building a bridge between the customer's purchase decision and the identity of the *takaful* product. Exhibit 10.16 illustrates some of the benefits that can be drawn out through the sales promotion of a family *takaful* education plan.

Exhibit 10.16

Sales promotional benefits of a family *takaful* plan

Source: Author's own

Public relations plays the role of spreading information and improving levels of knowledge that prospective customers hold about *takaful* as a concept, and about *takaful* products as a means to satisfy future financial needs. Public relations is a management activity used to shape the position of a *takaful* provider and its offerings in the mindset of its stakeholders. Public relations' methods and techniques include:

- lobbying;
- corporate advertising;
- crisis management; and
- investor relations.

Sponsorship builds an association between the image of the *takaful* provider and the event being sponsored. Sponsorship is a supporting tool for the other communications mix that aims to reinforce the *takaful* provider and the product offer's image. Events which may be considered relevant to sponsorship for a *takaful* provider are:

- sporting events;
- charity events;
- art events;
- educational events; and
- professional and industry-oriented events.

Direct marketing is the means by which the *takaful* provider can sustain, or sometimes create, personal communications with existing clients, potential clients and other stakeholders. Direct marketing is:

- complementary to other communications tools;
- the primary means to differentiate oneself from competitors' offerings;
- an informative tool; and
- a brand vehicle – building the brand name of the *takaful* provider or *takaful* product.

Personal selling allows the *takaful* provider to adapt its image and its offerings immediately, to meet customers' or prospective customers' requirements. This tool has a strong potency in the financial services industry, especially when communicating a complex product such as a savings and investment family *takaful* product with *takaful* protection benefits. Personal selling has special characteristics that make it more effective, but not more efficient, than other tools in the marketing communications mix. Personal selling is a major element of the marketing communications mix in the *takaful* industry when:

- there are a specific number of customers with special needs;
- a high level of information is required by customers and potential customers;
- there are high levels of involvement and the purchase of the product is of significant importance;
- a number of post-purchase actions are required;

- there is a great deal of product complexity;
- there is a focus on channel networks as a distribution strategy (banca*takaful*, agents, brokers, for example); and
- there is a flexibile pricing policy determined in accordance with the needs of individual businesses or customers.

Models of marketing communications

Takaful providers, especially in the current favourable atmosphere where there is a need for Islamic financial solutions, should interact with potential customers about the concept of *takaful* and the products available using modern and more complex methods of communication. In the past, financial services institutions tended to use a passive, one-to-many communications model. Due to advances in marketing and communications, financial services institutions are now competing to facilitate an interactive communications flow. In fact, the development in marketing communications, combined with the need to achieve superior performance, reinforced *takaful* providers to apply one-to-one communications methods for effective and efficient interactions.

Exhibits 10.17, 10.18 and 10.19 represent the three main communications models applied in the financial services industry.

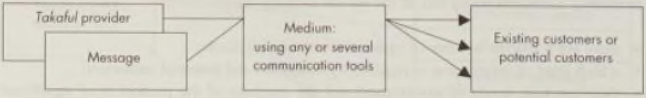
Exhibit 10.17 suggests the mass media communications process has no interaction between the *takaful* provider and customers or potential customers. *Takaful* providers can use communications tools to generate awareness about the firm or the offers utilising static media such as text, image and graphics, and/or dynamic ones such as audio, full-motion video and animation.

Exhibit 10.18 presents a simplified, one-to-one model of interpersonal communications. The arrows indicate the message flow from the *takaful* provider, through a communications medium, to two potential customers where dialogue takes place. This dialogue incorporates a feedback view of interactivity between the sender and receiver. The one-to-one model represents a given series of communications exchange that help the *takaful* providers to meet expectations.

While Exhibit 10.18 shows one-to-one communications between the *takaful* provider and two potential customers interested in *takaful* products, the model can easily be extended to represent many-to-many interpersonal communications. Interactivity is the key feature

Exhibit 10.17

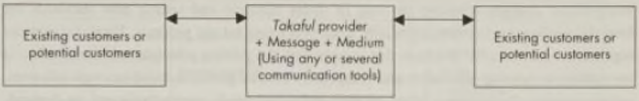
Mass media one-to-many communications process



Source: Author's own

Exhibit 10.18

Interpersonal, one-to-one communications process



Source: Author's own

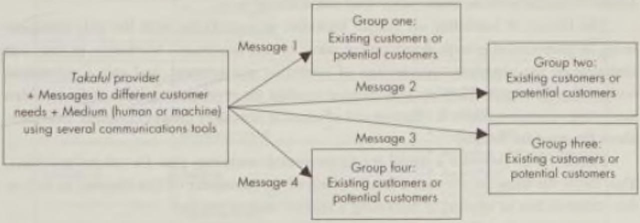
distinguishing the one-to-one communications process from the one-to-many. The medium used is important only as a conduit, as a means of connecting the *takaful* provider with potential customers. Exhibit 10.19 represents an effective communications process which provides interactions in a form of many-to-many.

The model in Exhibit 10.19 differs from the interpersonal one-to-one communication model in that interactivity can also be 'with' the medium (machine interactivity, for example a television) and 'through' the medium (human interactivity).

Takaful providers have to draw a structured matrix to compare different communications models. Due to the rapid changes influencing the financial services industry, competition is now taking place over a wider product range and forces such as *Shari'a* regulations, customer sophistication and technological developments have contributed to a more turbulent environment. These are reinforcing the need for *takaful* providers to follow the rapid growth in marketing communications.

Exhibit 10.19

A 'many-to-many' communications process



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Implementation

The development of marketing and communication methods has attracted a growing interest from the financial services industry, especially *takaful* providers. This has been based on the fundamental changes affecting the way of doing business and setting new standards for financial services applications especially when promoting *takaful* products. Financial services organisations which offer products that comply with the guiding principles of Islamic *Shari'a* are rushing to develop innovative and competitive Islamic products, build strategic alliances, segment and reach customers based on their individual needs, interactively and on demand.

The appropriate exploitation of new marketing methods offers unique research opportunities when evaluating the basic structure and design of *takaful* products in comparison with other financial services products. Effective and efficient marketing within a specific market facilitates a communications flow with customers and provides a large database of the needs and expectations of clients. This, in turn, builds the infrastructure for the development of *takaful* products.

Takaful providers need to understand the customer's buying behaviour and their acceptance of Islamic insurance as an alternative to conventional insurance. Based on the discussion above, it is clear that marketing methods affect several stages of the buying process. Given the unique system of Islamic assurance and assurance, customers or potential customers need to obtain information about the concept of *takaful* and products offered to evaluate and identify these differences. The process of marketing conventional financial services offers a working example for marketing Islamic financial services, including *takaful* products. The result of such offers significant dynamic potential for growth and development within the *takaful* industry.

Marketing Islamic financial products represents a fundamentally different challenge from marketing conventional ones. Modern marketing approaches, the many-to-many communications model, illustrate that there has been a paradigm shift in marketing processes which are applicable to any product offerings. Marketing professionals within *takaful* companies must consider carefully the ways in which marketing communications models may be adapted and reconstructed for the interactive, many-to-many, medium. Under this new communications model, customers interested in insurance products actively choose whether or not to approach Islamic financial services firms rather than conventional ones.

The impact of marketing on *takaful* providers is remarkable, with the only constants being its phenomenal growth, development, adoption and acceptance. Marketers, in time, can capitalise on the abundant opportunities of marketing management, and gain a substantial competitive advantage. They are now moving to adopt the revolutionary new media in which marketing communications is effective and efficient in providing greater customer awareness about the need for *takaful*.

Exhibit 10.20 provides a model for an integrated marketing plan for *takaful* providers. This forms the basis for the discussion in much of the remainder of this chapter, as to how this structure can be applied to marketing a specific *takaful* product.

Exhibit 10.20

Integrated *takaful* marketing plan

Executive Summary		
Contextual analysis	External analysis	• Industry
		• Competitor
		• Market
		• Customer
	Internal analysis	• Assets
		• Competences
		• Capabilities
Objectives	Marketing and marketing communication	• Specific
		• Measurable
		• Achievable
		• Realistic
		• Targeted
		• Timed
Strategy	Marketing strategies	• Differentiation focus
		• Cost/leadership focus
	Marketing communications strategy(ies)	• Pull
		• Push
		• Profile
Mix (tools)	Marketing mix	• Product
		• Price
		• Promotion
		• Place
	Marketing communications mix	• Personal selling
		• Sales promotion
		• Advertising
		• Public relations
		• Direct marketing
		• Sponsorship
The Schedule		
Budget	Affordable	
	Percentage-of-sales	
	Competitive-party	
	Objective-and-task	
Control	Annual plan control	• Sales
		• Market share
		• Market expense-to-sales
		• Financial
	Efficiency control	• Marketing mix
		• Marketing communication mix
Evaluation	Strategy	• Appropriate
		• Inappropriate
	Execution skills	• Bad
		• Good

Source: Author's own

An example of a three-year integrated marketing plan

I. Executive summary

The executive summary should illustrate the corporate direction of the *takaful* provider and the role played by the marketing department.

II. Contextual analysis

1. External analysis
   a. Industry analysis
   b. Market analysis
      i. *Takaful* philosophy.
      ii. Grand Counsel of Islamic scholars, Majma al-Fiqh, in Makkah, Saudi Arabia.
      iii. Market need/customer wants/cooperation and mutual help, and declared its compliance with the *Shari'a*.
   c. Competitor analysis (*takaful* and conventional insurance companies).
   d. Product (family (life) and general (non-life) *takaful* products).
   e. Customer analysis.
2. Internal analysis: Strengths, weaknesses, opportunities and threats

III. Objectives

1. Corporate objectives
2. Marketing objectives
   a. Generate/increase the overall market share (enlarge and enter new target markets), annually.
   b. Support in increasing the overall sales revenue annually.
   c. Support in increasing the overall sales volume.
   d. Support the current network channel and expand it based on customer and market requirements.
   e. Establish a developed marketing-information system.
3. Marketing communications objectives
   a. Generate/increase overall brand awareness by ensuring that customers know the *takaful* provider, annually.
   b. Generate/increase overall products and services awareness by ensuring that consumers know what are the offers provided, occasionally.
   c. Maintain brand attitude/equity for the targeted audience, continually.
   d. Educate and inform the market about the concept of *takaful* and the firm's offering, occasionally.
   e. Generate/increase market share, annually.
   f. Generate/increase customer interaction with the *takaful* provider and its offerings, occasionally.
   g. Create an atmosphere favourable for future sales through relationship building, continually.

h. Move the *takaful* provider forward by further penetrating the targeted segments, strengthening brand loyalty and refining awareness, recognition and attractiveness of the product, continually.

IV. Strategy

1. Marketing Strategy

   The *takaful* provider should focus on one or more narrow market segments within the targeted market. Management must get to know these segments intimately and pursue differentiation within the target segment.

   Marketing strategies must remain consistent with the company's mission.

   - Building on its significant brand-name recognition, the *takaful* provider should continue to emphasise serving the community through offering *takaful* solutions.
   - The *takaful* provider should communicate unique business approaches via different mediums designed to differentiate within the targeted groups, highlighting its commitment to operating in full accordance with the principles of the *Shari'a* and providing a full range of *takaful* offerings to the highest degree of service possible.

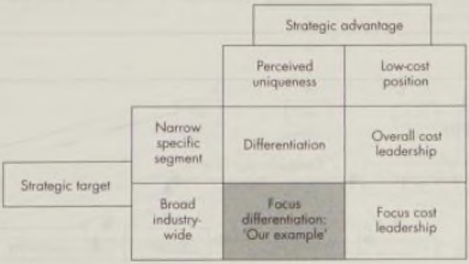
   Exhibit 10.21 describes a focus differentiation marketing strategy to achieve superior performance in an important customer benefit area valued by a narrow segment in a large part of the market through supplying superior *takaful* products.

2. Marketing Communications Strategy

   The *takaful* provider's marketing communications strategy is based on achieving marketing communications objectives that have been derived from the customer market. With respect to the corporate business plan and the nature of the industry and its products, the *takaful*

Exhibit 10.21

Focus differentiation marketing strategy



Source: Author's own

provider has to formulate marketing communications strategies to communicate with its target market: the end user and channel network. Applying the following strategies effectively and efficiently will result in achieving these objectives.

a. *Pull strategy*. Messages are directed to the *takaful* provider's end-users, aiming to generate increased levels of awareness, change and/or reinforce attitudes, reduce risk, encourage involvement, and ultimately successfully encourage customer adoption (see Exhibit 10.22).
b. *Push strategy*. Messages are directed through trade channels with the aim of presenting information that encourages them to take action on behalf of the *takaful* provider through allocating resources and becoming fully aware of the key attributes and benefits associated with each *takaful* offer with a view of adding value prior to further channel transactions (see Exhibit 10.23).
c. *Profile strategy*. The awareness, perception and attitudes held by stakeholders need to be understood, shaped and acted upon. This can be accomplished though continual dialogue, which will lead to the development of trust and commitment and enable relations to grow (see Exhibit 10.24).

Exhibit 10.22

Pull strategy

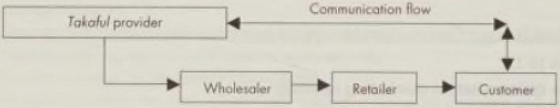


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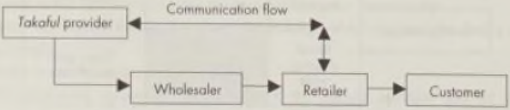
Exhibit 10.23

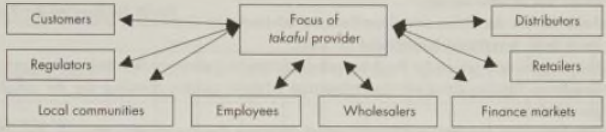
Push strategy



Source: Author's own

Exhibit 10.24

Profile strategy



Source: Author's own

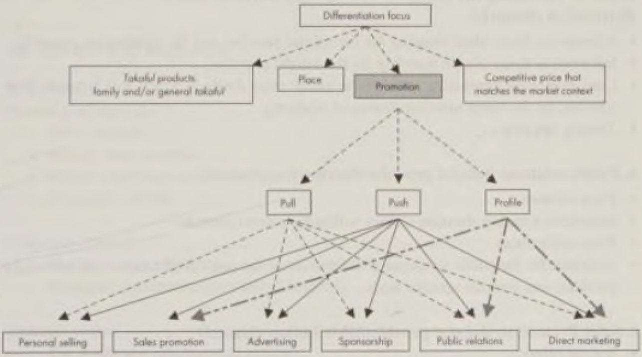
V. Mix (tools)

Exhibit 10.25 illustrates the integration of push, pull and profile strategies within a marketing communications mix for a *takaful* provider.

Advertisements, web pages and product descriptions are required for each of the steps in the marketing communications process. What follows are some examples of the marketing tools required.

Exhibit 10.25

Marketing communications mix



Source: Author's own

a. Personal selling (direct salesforce/financial advisors and/or distribution channels)

- Sales kit for the direct salesforce/financial advisors (introductory professional presentation, either soft or hard copies).
- Sales aid for the direct salesforce/financial advisors and distribution channels (cost-of-delay flyer, investment bulletin and the like).
- Personal financial review for the direct salesforce/financial advisors (fact-finding document).
- Brochures for the direct salesforce/financial advisors (single branding for the *takaful* provider).
- Brochures for distribution channels (dual branding for the *takaful* provider and the distribution channel).

b. Advertising (direct salesforce/financial advisors and/or distribution channel)

- Announcements of partnership/distribution agreement.
- Product launch press advertisement (dual branding for the *takaful* provider and the distribution channel).
- Product launch press advertisement (single branding for the *takaful* provider).
- Outdoor advertising.

c. Sponsorship (*takaful* provider/distribution channel)

- General activities (sports, charity, social, religious and the like).
- Business activities (conferences, forums, workshops for businesses and the public).

d. Direct marketing (direct salesforce/financial advisors and/or distribution channels)

- Informative flyers (dual branding for the *takaful* provider and the distribution channel).
- Information flyers (single branding for the *takaful* provider).
- Lead generation (marketing activities to gather mass database which will be used, after filtering, by the direct salesforce/financial advisors).
- Teasing campaign.

e. Public relations (*takaful* provider/distribution channel)

- Press releases.
- Interviews with key decision-makers within the *takaful* provider.
- Press conferences.
- Activities for the public to spread awareness about the concept of *takaful* and the *takaful* provider, and generate specific leads.

f. Sales Promotion (*takaful* provider/distribution channel)

- Special offers.
- Cross selling.
- Discounts.

VI. The schedule/budget

Exhibit 10.26

Schedule/budget chart

		Year 1				Year 2				Year 3			
Quarterly/Month		01–03	04–06	07–09	10–12	01–03	04–06	07–09	10–12	01–03	04–06	07–09	10–12
Strategy Mix													
Pull	Advertising												
	Personal selling												
	Direct marketing												
	Public relations												
	Sponsorship												
Push	Personal selling												
	Sales promotion												
	Advertising												
	Public relations												
	Direct marketing												
	Sponsorship												
Profile	Public relations												
	Direct marketing												
	Sales promotion												
Budget/Total		$	$	$	$	$	$	$	$	$	$	$	$

Source: Author's own

VII. Control and evaluation

1. Control

Annual plan control

- Sales analysis.
- Market share analysis.
- Market expense-to-sales analysis.
- Financial analysis.

Efficiency control

- Marketing mix efficiency.
- Marketing communications mix efficiency.

Strategic control

- The marketing effectiveness review.
- The marketing audit.

2. Evaluation

Auditing tools

a) Value-chain analysis
- Identifying ways of creating more customer value.
- Analysing a *takaful* company's capabilities.

b) Business/product lifecycle

c) Diffusion of innovation

d) Portfolio analysis
- Boston Consulting Group (BCG) (positioning).
- General Electric Matrix (GE) (positioning).
- Experience curve (cost management).
- Profit impact of marketing strategy.
- Gap analysis (cost management).

VIII. Marketing research

Primary data collection

a) Qualitative data: exploration (direct: group and in-depth interviews) and survey.

b) Quantitative data: description, cause and effect.

Conclusion

Marketing management is regarded as one of the fastest-growing and most influential factors in the development of *takaful*. Financial services in general have undergone a period of rapid change during the last thirty years especially with greater competition taking place over a wider product range. Communications in the financial services industry, on the other hand, experienced a rapid growth, particularly in Islamic offerings, mainly because of its infancy, complexity and the high competition rate caused by mergers and takeovers.

Recent economic, social and technological trends have had an impact on the demand for financial solutions combined with religious and cultural resistance towards conventional offerings. The result of such trends prompted *takaful* providers to manufacture their offerings based on getting to know the customer and understanding what influences his or her decision to purchase *takaful* products. In order to understand the needs and motivations of *takaful* customers, financial services institutions have to identify the relationship between the *takaful* product offered and the needs of customers; especially by focusing on the buying behaviour, levels of involvement and types of decision-making.

Marketing communications tools represent effective and competitive solutions to providing cost-effective marketing through innovative mediums. An appropriate analysis of the context, clear identification of the business scope, and accurate selection of the marketing mix might achieve greater communications between *takaful* providers and the targeted group. Moreover, this neat solution provides cost savings, many-to-many product transformation, globalisation, and competitive penetration.

In the main, this chapter is based on the practical application of the marketing theories by the *takaful* provider, Solidarity. As marketing management and the use of communications

in this industry is a growing subject that has attracted considerable attention, it is still too early to evaluate its success. Factors other than the appropriate application of marketing management have played a significant role in the current success of Islamic financial services, in particular the growing demand for family and general *takaful* products. Potential customers globally are realising the scope of this ever-expanding system of insurance and assurance in providing safety and protection against the widest possible risks, along with a diverse range of prudent saving and investment opportunities.

Marketing management is an essential factor that offers unique benefits for *takaful* providers while targeting specific customer segments. When applying any distribution strategy, through a direct salesforce or banca*takaful*, marketing management offers financial firms a global many-to-many communications approach to reach several markets. It allows the transfer of information about *takaful* product offerings between several and different targeted groups. It also opens the opportunity to gather market intelligence and monitor customers' choices for more satisfaction.

In terms of marketing communications, the different communications tools provide information about the concept of *takaful* and its products. The interactive aspects of these tools could be employed to develop customers relationships. In operations, *takaful* providers benefit from marketing to build a bridge that communicates market needs and hence helps in designing innovative products. There are other benefits, such as the creation of new markets and segments, the increase of lead-generation, easier entry into new markets, and facilitation of faster time to sell. Understanding the needs and behaviour of potential customers is critical to improving the *takaful* institution's marketing approach. Whatever the marketing strategy employed, it can only work effectively and efficiently through utilising client knowledge and situational analysis.

The subject of customer acquisition and retention is receiving much-needed attention from many financial services institutions. Top-level decision-makers are making substantial investments in developing business strategies, operational infrastructure and innovative products to address the needs and preferences of their targeted groups. However, without appropriate communications the message will not find a place to park.

Takaful providers should take the initiative to develop and implement their marketing approaches derived from customers' knowledge to shift from being predominantly transaction-based to predominantly relational. This shift will ensure superior ongoing relationships with customers, distribution channels and other stakeholders, as well as helping in generating awareness about the need for future Islamic financial solutions and the concept of *takaful*. As the marketing of conventional financial services offers a successful working example, *takaful* providers should adopt the existing communications infrastructure and add their own philosophy to facilitate the creation of an active and interactive environment for multiple communications feedback. Without such a creation, the *takaful* industry will face competitive disadvantages next to other financial offerings.

Chapter 11

Distribution of *takaful* through joint venture partners

Keith Driver
HSBC

Introduction

Distribution is a topic of concern and attention regardless of whether it is *takaful*, conventional insurance or any other product. It is the core value-generator of any business and without effective distribution, regardless of the quality and utility of the available products, all businesses are doomed to fail. The question addressed in this chapter is whether joint ventures have any distinct distribution advantages over normal start-up operations. Start-up operations have been chosen because few established businesses move to become joint venture (JV); they either become widely held or acquired, each of which has its own challenges but are separate from this topic.

Whether JV partners are at an advantage obviously depends on the engagement of the partners. This includes:

- whether the partners have any relevance to the business;
- the clarity of the business model; and
- the alignment of the brand and image between the new company and the parents.

Shareholders, partners and stakeholders are used interchangeably in this chapter; they are not normally equivalent but in the case of distribution partners, they are all special-access alternatives to access customers.

To explain the issues involved a structured way, in order to assess the approach to distributing through JVpartners, the following topics will be discussed:

- the business model (how will the business operate?);
- brand/image alignment (does the new business fit with the parents?);
- product selection (priority, relevance, profitability);
- prioritisation (which partner, when, efficiency of success, support);
- training (product knowledge, system operation, new/old, service standards);
- quality control (ongoing support and alignment with objectives and standards); and
- risks (what can go wrong using a partner).

Business model

The *takaful* company needs to know what kind of business it will undertake and what its character is in order to assess how it will operate and whether it needs partners to distribute. In the current environment, much is suggested about 'direct' models of distribution, but in reality, few markets and products are yet able to support a full insurance proposition without partners, agents or a 'real people' salesforce. This is especially true for *takaful* and for markets in which *takaful* is likely to take root in a meaningful way (the Middle East and Asia Pacific). In the more developed markets, *takaful* is destined to be a niche market for the foreseeable future and as such it may or may not leverage an existing provider's strategy or infrastructure to bypass partner distribution. For now we will focus on other, less-developed markets.

Once the management team has determined the business model, the opportunity to assess the value of the partners can begin. Other areas in this book will address some of the potential models and strategies, so this chapter assumes that this is about a business model that chooses to leverage partner channels as a first initiative. There are many reasons to choose such a model and strategy: access to common customers, a lower potential cost of customer acquisition, common industry and cross-selling potential, shared revenue streams to leverage returns on shareholder investment and the like. These can all be powerful reasons to work with partners and to do so as a priority for the business and the shareholders.

Additionally, it is very likely that the partners have chosen to establish the new business for clear and predetermined reasons that include distribution by themselves. It is important to note that these reasons need to be validated in the cold, hard light of day when the business is being established and the practicalities are encountered. This underlines the critical decisions taken by the business during formation and strategy development, whereby the new business is established in order to effectively connect and use the partner's distribution capabilities.

Brand/image alignment

Having identified the value in working with the partners for distribution, it is imperative that the business identifies its brand value and proposition. What is the new business identity? Beyond this, does the new business have anything in common with its parent companies? In order for there to be an effective discussion with the partner about the new business and its products and services, there should be some common connection, objective, philosophy or even branding values so that the customer sees the benefit without thinking about the connection or worse questioning whether it is logical. In the instance of a bank which has engaged to set up a *takaful* company, there are many possible alignment benefits:

- financial services covers banking and insurance;
- people taking loans have needs;
- customers saving for retirement or children's education have needs; and
- people accumulate possessions and assume responsibility for others (spouse, children, parents and the like) there are needs.

Where a conventional insurance company participates in establishing a *takaful* company, there are other needs which are aligned:

- accessing new segments;
- broadening the product range to meet political or demographic changes; and
- responding to emerging needs of their existing customers.

Regardless of the basic premise for entering the business, the effectiveness of the partners in offering value to the new business is partly a function of whether the image of the businesses have enough (or anything) in common such that customers see it as making sense. If the partner has market feedback on its image with the public then you have solid information in determining which parts of your business image you will want to promote with the partner. If they do not have a clear view of what they are seen as externally, then ask the management team to give you some ideas on what their competitive advantages are and align with that until market research or customer feedback gives you better information. Without this alignment, distribution will require substantial effort and investment.

Product selection

The decisions taken about product development and roll-out need to be carefully considered when evaluating distribution through JV partners. Products that are profitable or that are focused specifically for the new business may not be appropriate for distribution through connected partners. There is a need for clear and honest discussion about which products can be sold and which products are mutually beneficial to be sold via JV partners. A number of factors should be taken into consideration when deciding priorities, such as:

- past history of selling any insurance or *takaful* products;
- their track record in effectiveness across products;
- the current state of the distribution channels used for these products;
- staff experience or qualifications;
- for what other products are these sales channels used; and
- how much dedicated time can be committed to make sales of the new *takaful* products successful.

In addition, it is valuable to determine if there is any critical time period during which products should be targeted for launch: renewal opportunities, seasonal variation, and associated product promotions (home loans for fire insurance and the like). It is best to align the business with the easiest path for initial product distribution to reduce the effort required to prepare the sales channel. There will always be a need for training on product details as well as operational procedures and the more that these can be aligned with existing products and practices the easier the discussions and roll-out will be.

Additionally, the priority in product selection should reflect a sound understanding of the ability of the new business to actually deliver on time. Partners will forgive many things in a start-up but will not tolerate putting their existing client relationships at risk. It is critical to understand the deliverables and the tolerance factors. These include:

- regulatory approvals;
- product development timing;

- system readiness;
- operational preparedness;
- marketing lead times; and
- (incredibly important) the partner's own timeframe for any notices or preparations as well as their standard product roll-out approval process.

To promise and not deliver to a partner is even more difficult than letting down an independent distributor, though that is different for the business in different ways. Your partners will be at every board meeting and have ready access to you for budget and remuneration!

Finally, as with all customers and distributors, they want everything 'fully optioned' and at the cheapest price. There will be a mix of business that is valuable for both businesses and there should be an open and honest conversation about where that mix is and when it can be expanded to include more products. The key focus is profitability (or customer acquisition) and critical mass volumes. Fringe and 'nice-to-have' products are for the second phase, whenever that is. Falling into a dysfunctional relationship with partners that make valuable distribution income when the new business is unable to turn in a profit will drag on the relationship and pull the two teams apart from a very early stage.

Partner prioritisation

In some cases, a new business will have more than one stakeholder with which to work on distribution. It is therefore important to be clear about the strategy and the logistics of each in determining how to move forward. It is enticing to look at all partners for a common launch, either to keep them happy or to avoid a fight over which partner is priority. But there are differences between different partners in value-addition for the new business and that needs to be carefully explored and explained. There are reasons for being selective in the beginning, most likely focusing on one partner and getting that right and then looking at others. This selective approach allows the new business to align its operations and people with success, achieve one set of demands, and agree on clear product and service standards. It is highly unlikely that two similar businesses will be investment partners in the JV and as such there will be a variety of issues covering support and service that require different solutions and investment. These include:

- systems linkages;
- staff support;
- training requirements;
- product features;
- product types (family or general, complicated or simplistic, and the like);
- marketing approach;
- brand alignment and company positioning;
- fitting new products alongside or as a replacement to existing versus starting distribution from scratch;
- recruitment;
- quality control; and
- compliance controls.

In short, picking your first partner is based on what you think is the most likely avenue to a successful launch and which one is most aligned with your business already. None of your partners/shareholders will welcome a failure, even if they would have preferred to be the first to be included. In being selective, you limit the degrees of difficulty to a manageable set of problems and can begin to take care of them. The next channel can be determined based on a relative success and experience of what went wrong.

Once the selection has been made it is crucial to keep JV partners informed of progress (or lack of it) in order to manage the risks and dangers of delivery being delayed. Remember that no matter how hard it is for your business to get itself organised, the JV partner will have an existing business which is insensitive to these trials and tribulations and merely wants to 'show off' its new business to its customers. You have to keep them engaged and excited about the venture. However, this carries the risk of letting them down, so it is best to manage expectations in advance so that they do not get backed into a corner with their clients.

Training

While there is much training for any new *takaful* company, there is little that can equate with preparing the sales channel to represent your company. They are typically busy with the work they were undertaking before you came along, and as such are not overjoyed about adding something else to their repertoire. By ensuring substantial commitments on training to prepare the sales and wider support staff in your JV partner's offices, you improve the likelihood that they will represent your business the way you desire. Nevertheless, there is more to this than product training; there is a need promote the business in a constructive and positive light. It is virtually impossible to give too much good training and very easy to give too much bad training. Good training is that which is engaging and focused around what are the distributor's issues, and how they can overcome any questions they expect to receive. As with any effective discussion, the recipients are more interested in solving their problems than in solving yours. It is important to become involved with the sales and operations staff early in order to understand whether and how much your products and processes will be different from those they already know. If you can be clear about these issues, then the product details and other elements necessary to be successful will be easier to acquire to expand their knowledge. Training is your company's sales pitch to the distributor: you are selling and you hope that they are buying!

Similarly, it is important for the management of the new business to be involved in the training and visit the JV partner's site to understand firsthand what problems and questions arise from the actual people in the field that will sell your product. Without this understanding, there is no way that the management team can understand what adaptations are necessary, or where there may be problems that have to be overcome and supported. This 'reverse' training is crucial in supporting your partner in distributing your products. It allows you to discuss with directors and with senior operating management what solutions or remedies are needed.

Quality control/sustainable sales

Once the JV partner is selected, products agreed and developed, and preparations undertaken to train, market and prepare the teams to sell the products, the ongoing performance is key.

Quality control is important to factor in from the beginning because it allows you and your partner to discuss success as a common objective and in a common language. Whatever the normal quality-control mechanism for the JV partner, your business should fit within that regime and become a part of their normal process. In addition, you should ensure that your team conduct 'mystery shopper' or other exercises to follow up on the way your products are represented to the public. Where there are shortcomings (or even open resistance to the products), the process needs to be improved and dialogue held to return to a positive sales positioning. Typically, the ongoing sustainable relationship will fall to the *takaful* company to maintain, or else the partner will look only at renewals in a year's time. Where there are successes, it is important to recognise these directly rather than rely on the partner to acknowledge the staff or area that is successful. However, it is advisable to discuss the style and form of recognition with the partner to make sure that there is no conflict with the partner's own recognition schemes, or possibly to work out a collective way to promote the successes around the partner's network as a way to increase competitive challenge among the districts or teams.

Above all else, the quality control of the sales process and customer experience has a double impact on your business; the customer's experience from the partner's staff as well as your business' fulfillment of the ongoing promises that they have made.

Risks

The key issue in working with a partner as a distributor is remembering that a partner is for life. They are with you at every step of the way and have double exposure to working with you; losing money and affecting their existing client relationships. As such, it is vital to make sure that every step of the way is clear and transparent for them to back you and support your business. This requires communication, and then repeated communication. This is absolutely vital. Repetitive communication is needed because they will normally assume that you understand their established business and the processes with which they are already familiar, and which is probably well documented. Additionally, they will have a history of dealing with already-established businesses and not with start-ups that have high levels of uncertainty in delivering products or being in control of their destiny.

The core risks therefore are failure to:

- communicate clearly on objectives and confirming that the message is heard;
- deliver on time;
- properly embrace and understand 'their' processes and timelines;
- listen to them about distribution issues and obstacles;
- train them to sell the business not just the product;
- communicate clearly on progress and setbacks at frequent intervals;
- engage the partner's operations and sales teams early on;
- quality-control the sales experience to remedy problems; and
- keep the other stakeholders in the loop on their involvement.

This list is not exhaustive and not much different than any list of things not to do in working with a distributor; but it sheds light on the darker side of using stakeholders naively. They

offer great power but they are not predestined to make your business a success overnight. If you fail them, they will be around at every board meeting and budget approval.

Conclusion

In the end, distribution through JV partners is both a blessing and a curse. Where there is clear alignment and common objectives, the relationship is powerful and constructive. However, it carries substantial risks in going wrong and in trying to please too many masters at the same time. The shareholders have invested in the business for specific reasons, but these reasons may or may not be in line with the immediate market opportunity or even those in the future. Similarly, JV partners want most of all to be successful, and they always feel that they have something to contribute. By all means, embrace their contributions and seek out ways to leverage these to make the business successful. Using them as distributors is very effective and useful in building a presence and a brand for the company and, generally, in bringing *takaful* to more customers more quickly. The cost of customer acquisition through partners is likely to be comparatively low if the partners have a product or service proposition which lends itself directly to *takaful* (such as those in banking, conventional insurance, investments, and even indirect industries such as construction or lifestyle services). Where there is an avenue to develop a sales base with a partner, this is a valuable way to provide an additional income stream to your investors, which helps justify their investment earlier than the company can pay dividends and as such will be welcomed. However, there is a need to be very transparent and upfront with the partners about why they were chosen, and especially why they were chosen over alternatives. Also, there must be transparency about what products you will sell with them and about what is needed to make this a success. It is critical to keep JV partners involved in the process and ensure that all necessary work streams are established to deliver the products and to understand their process and match (or even to run parallel product roll-outs) in order that partners remain comfortable, and that there is as little change as possible to what they know and are busy making money doing.

Chapter 12

Asset management within the *takaful* industry

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Oasis

Introduction

Islamic insurance, or *takaful*, has grown in its popularity as a viable *Shari'a* compliant alternative to conventional insurance products. *Takaful* involves the sharing of risk amongst participants seeking to protect themselves from any potential future loss (either to assets or lives). This can be done through the pooling of funds. These funds need to be invested in a manner that will ensure consistent above-inflations returns with a low-risk profile.

How does *takaful* operate?

Exhibit 12.1 illustrates the two parts to the *takaful* model: first, the underwriting that is required on behalf of participants; secondly, the assets used to settle any potential claim liabilities. It is the latter part (investing activities) that is the subject of this chapter.

As with any conventional insurance company, matching assets with liabilities is of utmost importance. Therefore, the management of the participants' assets needs to be done in such a way that funds are always available to make payments to participants. The use of a professional, proven asset manager is vital. Ensuring downside protection can be a key success factor in managing assets on behalf of *takaful* operations.

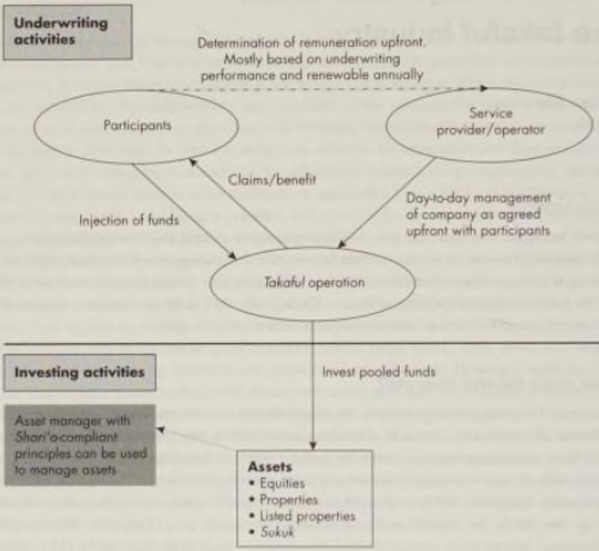
Incidents such as accidents and natural disasters amongst others can occur at any time. To meet the obligations associated with these potential liabilities, sufficient capital is required on the part of the *takaful* operation to manage payouts. Payouts should be made within a reasonable period of time (in order to offer the best service to participants and at the same time to be competitive), thus requiring assets that have adequate liquidity and quality.

A *takaful* operation has recourse to both re-*takaful* and participants' assets in order to meet any potential claims. Thus, both these sources of recourse are of vital importance to a *takaful* operation. The global re-*takaful* market is growing in size, and thus capacity in the re-*takaful* industry is set to increase.

At the time of writing, conventional insurance has a much larger investment universe to meet this requirement: bonds and other money market instruments are widely available and liquid globally. On the other hand, *takaful* can use *sukuk* as a *Shari'a* compliant alternative. *Sukuk* offer very similar characteristics to bonds, and there has been an increased awareness coupled with amplified activity in the *sukuk* market in recent years, as adequate returns have

Exhibit 12.1

The underwriting and investment activities of *takaful* providers



Source: Author's own

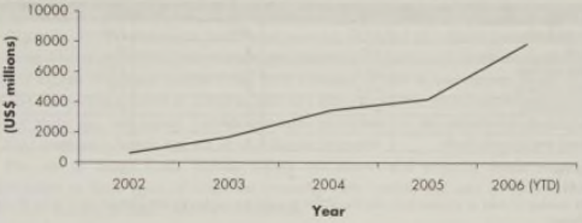
been generated on these instruments and because of their reduced-risk profile. Credit rating agencies have also identified *sukuk* on their radar screens, as is clear from the number of *sukuk* issues that are being rated. Furthermore, the costs of issuing and marketing *sukuk* are reducing as bankers and investors become more familiar with them.

As Exhibit 12.2 illustrates, the global *sukuk* market has increased considerably in terms of size since 2002. Furthermore, as stated above, the quality of these issues has also increased as evidenced by the high credit ratings awarded to certain *sukuk* issues.

In order to manage the returns on participants' assets, the use of a *Shari'a* compliant fund manager with an excellent track record who applies a low-risk investment philosophy

Exhibit 12.2

The growth in the global *sukuk* market



Source: Citigroup

can be a winning alternative. This type of strategy, whilst ensuring relatively low levels of risk, generally provides superior returns. In fact a low-volatility fund manager can be viewed as a 'one-stop investment shop' as it will provide several products tailored for different needs on a single platform, available for individuals to pension funds. A major positive characteristic of investing in pooled funds is that unitholders are able to access their funds within short notice (a two-day lead-time is generally required). Furthermore, due to the size of such pooled funds, there is a lower impact on these funds in the event of withdrawals. If we assume that *takaful* operations use such a manager as part of their asset class, this should allow for a smooth payout process in the event of a claim.

Types of assets

Funds under management should comprise low-volatility, liquid assets that provide inflation-beating returns. Exhibit 12.3 highlights the varying liquidity, volatility and inflation-hedge characteristics of differing asset classes. The Exhibit demonstrates that private equity, hedge funds and closed -end property funds are not appropriate as an investment tool in a *takaful* operation due to their lack of liquidity and increased volatility. This narrows the investment universe to listed equities and property, income funds and *sukuk*, which leads us to the investment decision to be taken. This is discussed in more detail below. Income funds are included, as most regulatory authorities require pooled funds to hold a certain portion of assets in such investments to provide short-term liquidity.

Exhibit 12.3

The relative characteristics of different asset classes

Investment type	Liquidity	Volatility	Inflation hedge
Income funds	✓✓✓	✗✗✗	✗✗✗
Sukuk	✓✓	✗	✗
Listed equities	✓✓✓	✓	✓✓✓
Listed property	✓✓✓	✓	✓✓
Private equity	✗✗✗	✓	✓✓
Hedge funds	✗✗✗	✓✓✓	✓
Closed end property funds	✗✗✗	✗	✓

✓ = Yes
✗ = No
(The number of ticks or crosses indicates the ability to meet the necessary requirement on a scale of one to three.)

Source: Author's own

Investment decision

The decision taken on the investment of *takaful* funds depends on the type of *takaful* offered, normally differentiated by general or family *takaful*.

General *takaful*

General *takaful* includes, amongst others, motor vehicle cover and business cover. This type of *takaful* has a short-term time horizon (that is, it is renewable after 12 months). Due to these characteristics, the underlying assets need to be liquid in nature in order to speedily meet any potential claims. Finding the type of fund manager described above, who offers a fund with a high component of income, is a means of ensuring low downside risk and thus capital protection as well as providing regular income. An example of the asset allocation of such a fund can be found in Exhibit 12.4.

Exhibit 12.4

Potential asset allocation of general *takaful* funds

	% of portfolio
Equities – listed	40
Sukuk – listed	40
Property – listed	10
Income fund	10

Source: Author's own

As a low-risk fund manager, the fund will depict a high Sortino ratio, which indicates higher return for each unit of downside risk in the fund (definitions on ratios are provided at the end of this chapter). At the same time, the exposure to equities will provide the required liquidity in order to meet speedily any claims that become due. Income funds are normally kept in the portfolio in terms of regulatory requirements – these funds also provide short-term liquidity. Dividend income from listed equities and *erad* (dividends from *sukuk*) can also be used to meet potential claims under the general *takaful* scenario. In the event of claims being in excess of income received, the fund manager is able to use income funds in the portfolio or liquidate equities or *sukuk* to meet any claim liabilities. As discussed above, these types of assets are very liquid, provide downside protection (on the assumption that a low-risk fund manager is used) and act as an inflation hedge.

The use of hedge funds, private equity and closed end property funds would be inappropriate as these types of funds are generally very volatile and may be illiquid in the short term, leading to asset-liability mismatches.

Family *takaful*

In the case of family *takaful*, most participants aim at saving for their long-term needs, for example their children's education, their pension and compensation for dependents in the event of death, amongst others. Therefore, the timeframe in this regard is one of a long-term nature (it may be anywhere from 10 to 30 years). Bearing this in mind, the type of underlying investment required would differ somewhat from that needed for general *takaful*.

Liquidity is relatively less important in the short term, yet investing in a portfolio with high equity exposure still provides adequate short-term liquidity. Choosing a fund with a high degree of capital protection (low risk), good returns and adequate liquidity should be ideal for family *takaful*. Exhibit 12.5 provides a possible asset mix.

A higher exposure to domestic and international equities (when compared to general *takaful*) is more appropriate in this regard as the investment horizon is one of a long-term nature. This also allows for adequate asset-liability matching due to the long-term nature of liabilities and the corresponding investment. Once again hedge funds are not considered appropriate due to the excessive volatility associated with funds of such a nature.

Exhibit 12.5

Potential asset allocation for a family *takaful* fund

	% of portfolio
Equities – listed	55
Sukuk – listed	20
Property – listed	10
Income fund	5
Property – unlisted	5
Private equity	5

Source: Author's own

Exhibit 12.6

Example of *takaful* investment strategy

	2001	2002	2003	2004	2005	(YTD) 2006
Fund A - Low-risk investment philosophy, as described	-2	-1	33	22	12	10
Dow Jones IM Index	-19	-22	30	11	10	5
Average *Shari'a*-compliant global fund	-18	-19	25	7	4	4

Source: Author's own

Exhibit 12.6 compares Fund A (a *Shari'a* compliant fund that is characterised since inception by a low-risk investment style and adequate downside protection) to the Dow Jones Islamic Market Index (a benchmark index for *Shari'a* compliant funds) and the average *Shari'a* compliant global fund, in terms of absolute performance for a five-year period (2001 to 2005) and year-to-date 2006 (July). It can be seen that Fund A has done well (capital protection) in the tough market experienced in 2001 and 2002 in comparison with the market and competitors. The low-risk philosophy of Fund A has not only worked in bear markets, but also in bull markets where it has outperformed both the market and its competitors (through 2003 to 2005). A similar trend for year-to-date numbers is evident.

Had Fund A been part of underlying investments in a *takaful* operation over the five-year period, assets would have easily matched any potential claims' liabilities as there was sufficient capital protection and high returns (in excess of inflation). To further understand the risk profile of the fund, an analysis of the Sortino and Sharpe ratios against benchmarks is given in Exhibits 12.7 and 12.8.

Based on the characteristics of Fund A described in this chapter, the Sortino ratio and the Sharpe ratio clearly show the low volatility and quality of returns against the benchmark

Exhibit 12.7

Analysis of the risk profile of Fund A

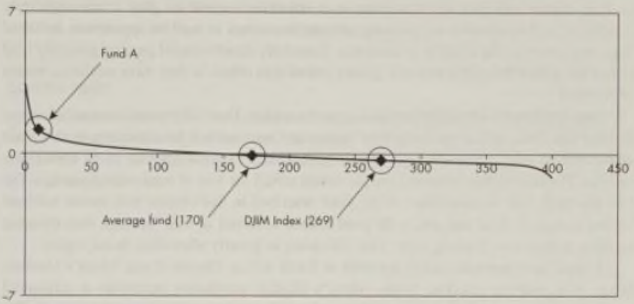
	Sortino		Sharpe	
Global funds versus benchmarks	**Ratio**	**Ranking***	**Ratio**	**Ranking***
Fund A	1.22	8th	0.98	7th
Dow Jones IM Index	-0.15	269th	0.01	264th

* ranking out of 401 global *Shari'a*-compliant funds.

Source: Author's own

Exhibit 12.8

Fund A performance: Sortino ratio



Source: Author's own

Exhibit 12.9

Fund A: Capturing market downside

Target: To capture less than 85 per cent of the downside	Average Return in a Bear Month (%)		Average Downside Captured (%)	Target Achieved (%)
	Fund A	Dow Jones Islamic Market Index		
	-1.7	-3.8	45%	✝

Source: Author's own

index. The risk-adjusted return on Fund A places it in the top 10 in terms of ranking out of a total of 401 companies.

Markets generally have bull and bear runs. Since inception, Fund A has an investment philosophy of capturing less than 85 per cent of downside movement relative to the market and benchmark in times of a bear market. As can be seen from Exhibit 12.9, this strategy has been successful in that it captured 45 per cent of the average downside of the market over a five-year period. This would be favourable in the event of a payout being required, as it minimises asset depletion due to any market downside.

Takaful in Africa

A significant proportion of the African Muslim population in general is relatively poor, with over half of Africa's Muslims residing in underdeveloped countries. Furthermore, social services in most African countries are inadequate or do not exist. *Takaful* can play a meaningful role in alleviating this dilemma by allowing affordable savings as well as appropriate levels of insurance cover. In the absence of insurance, financially disadvantaged persons generally tend to feel the after-effects of a loss to a greater extent than others as they have minimum means of recovery.

Family *takaful* is of vital importance in such a region. This will provide a means of saving for participants as well as an element of insurance. Once again, a fund manager as described above will be able to manage funds placed with a family *takaful* operator in an appropriate manner. Financially-disadvantaged people cannot afford the loss of hard-earned savings. The low downside risk characteristics of the fund described in this chapter will ensure minimal capital erosion in bear markets, with good returns achieved in bull markets, thus ensuring superior returns over the long term. This will assist in poverty alleviation in the region.

Takaful has enormous upside potential in South Africa. Despite South Africa's Muslims being in a minority position, South Africa's Muslim population represents a substantial contributing portion of the total population, as they are a highly productive and economically-active group of people.

Evidence of this is the fact that there are several asset management companies that have significant assets under management in *Shari'a* compliant funds. Furthermore, most of the countries' major banks have introduced *Shari'a* compliant banking products aimed at Muslim customers.

Conclusion

In conclusion, the use of a mutual fund as an underlying investment will provide a viable alternative to the global *takaful* industry. Mutual funds are regulated and transparent in pricing and performance. Furthermore, assets held in such a fund are available on short notice. Mutual funds with the characteristics described above can aid in the development of *takaful* in Africa.

The management of assets held by a *takaful* operator plays an important part in running a successful *takaful* operation. These assets are the only means (along with re-*takaful*) available to make payments to participants in the event of a claim. Therefore sufficient funds should always be on hand to meet these requirements. A reputable asset manager, with an excellent investment record and a low-risk, low-volatility investment approach is the ideal fit for the management of *takaful* participants' assets. The growing, yet fledgling, *takaful* industry adds yet another tasty piece to completing the *Shari'a* compliant financial services puzzle.

Glossary

Investment income

Income derived from investments that are made by the *takaful* operator using pooled funds provided by participants which are obtained by the *takaful* operator through the collection of premiums. All investment expenses are also offset against this income.

Sharpe ratio

A measure of the risk-adjusted return of an investment. It is used to evaluate the quality of the returns of a fund. The higher the value of the indicator, the better the quality of the returns, on a risk/reward basis. A Sharpe ratio that exceeds zero indicates a return in excess of the risk-free rate that is relevant to the investment context.

Sortino ratio

A downside risk/return ratio that measures the return of a fund, in excess of inflation, against harmful volatility. The higher the ratio, the higher the return for each unit of downside risk unit in the funds. A negative ratio indicates that a fund has underperformed inflation for the level of downside risk.

Chapter 13

Strengths and opportunities of *takaful*: the spiritual dimension

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Introduction

The purpose of this chapter is to reflect upon opportunities available to *takaful* operators[1] to think out of the box and leverage their unique strength to offer something above that offered by conventional insurers. Some of the concepts discussed below, although unconventional, are put forward on the assumption that there are customers who expect more than the usual material benefits. It is important to understand that, to some customers, spiritual benefits can be as important if not more important in their buying decision.

Background

The first *takaful* operator in Malaysia was established in 1985 following the recommendation by Badan Petugas Khas' (BPK), the special taskforce commissioned by the Government in 1982 to study the feasibility of setting up Islamic insurance in the country. The provision of a separate legal framework to regulate the *takaful* business in the country was also recommended. The Malaysian Parliament legislated the Takaful Act 1984[2] for this very purpose. This is one example of the Malaysian Government's response to a number of demands from faithful Muslims who prefer to conduct their economic activities according to *Shari'a* principles.

The demand for *takaful* is a clear indication that conventional insurance is not able to serve the spiritual needs of Muslim customers. This provides opportunities for *takaful* operators to fill the spiritual gap and have competitive advantage over their conventional counterparts.

Having said that, it must be clarified at the outset that this does not mean *takaful* is exclusively for Muslims. People of all faiths are eligible to join.

Shari'a compliance

Whilst conventional insurance and *takaful* may have a number of practices that are similar, the *Shari'a* law also contains fundamental principles which need to be observed. To ensure this is correctly applied, the Takaful Act 1984 makes it mandatory for each licensed *takaful* operator in Malaysia to be supervised by a *Shari'a* committee comprising approved *Shari'a*

scholars. Muslims who are conscious of their religious obligations derive comfort from such an assurance and consider this an important factor in their buying decision.

Indeed *Shari'a* compliance has been the main value proposition that *takaful* operators have relied upon from the very beginning.

Surplus sharing

Another value proposition upon which *takaful* operators in Malaysia leverage is the practice of surplus sharing. At the time of writing, all *takaful* operators in Malaysia, irrespective of whether they practice under the mudaraba or *wakala* models, offer to share the net surplus of income over liabilities in the *takaful* funds according to a pre-agreed ratio such as 50:50, 40:60 or the like. The prospect of receiving a refund is an attractive value proposition to many customers, irrespective of faith. Since conventional insurers in Malaysia do not offer this, many Malaysians assume that surplus sharing is a feature unique to *takaful*.

However, after 20 years, customers tend to take these two features for granted and expect all *takaful* operators to offer them refunds and *Shari'a* compliance as a matter of course. With competition becoming more intense, *takaful* operators can no longer rely on these two features as the only value proposition.

Muslim customers expect *takaful* operators to offer the same benefits as conventional insurers, yet remaining *Shari'a* compliant. Such high expectations cannot be avoided in Malaysia as the country operates a dual financial system where both Islamic and conventional financial institutions battle head-on in a highly competitive environment.

To compete successfully, *takaful* operators need to differentiate themselves by offering value-added services that conventional insurance cannot. The key is to understand the needs, behaviour and preferences of the targeted customers from their perspective, and not that of the *takaful* operators. Only when these are fully understood can *takaful* operators strive to innovate and achieve greater customer satisfaction.

Differentiation strategy

According to conventional wisdom, innovation is usually limited to fulfilling customers' material or worldly needs with benefits such as lower prices, higher returns, faster delivery, wider scope and the like. Spiritual needs, which can be as important to certain customers, do not receive a lot of attention.

It is believed that the spiritual dimension of *takaful* is one area where *takaful* operators have unique abilities on which they can leverage to delight a certain customer group. Herein lie opportunities for *takaful* operators to innovate. This does not mean that the so-called material benefits are not important to *takaful* customers. In fact they are just as important. This chapter, however, focuses on meeting the spiritual needs of *takaful* customers and potential customers.

The following paragraphs highlight some unconventional ideas on innovation on which *takaful* operators can leverage to achieve a competitive advantage over conventional insurance. Some of these ideas are founded on the belief that people would 'feel good' (and thus, derive value) while helping those in dire financial need.

Critical to this discussion is the fundamental difference between conventional insurance and *takaful*. Understanding this is necessary to enable readers to follow, even if not agree, with, the thoughts put forward in this chapter with respect to innovation in the *takaful* arena, which are key to appreciating the opportunities available to *takaful* operators.

The fundamental difference between *takaful* and conventional insurance

At first glance there does not appear to be considerable difference between insurance and *takaful* as both use the concept of the common pool where the fortunate many help the unfortunate few. However, *Shari'a* scholars are generally of the opinion that to be *Shari'a* compliant for insurance, the premium must be paid on the basis of *tabarru'* (an Arabic word meaning donation, gift or contribution).

In the BPK report, for example, it was recommended that, for insurance to be permissible according to the *Shari'a*, part of the contribution (premium) must be made on the basis of *tabarru'*. Here is an English translation of the relevant paragraph.

> Under the Islamic insurance system, part of the contributions from every participant must be made with the intention of *tabarru'* – not for buying/selling, the existence of *tabarru'*, makes the transaction permissible and valid according to the *Shari'a*.[3]

This is consistent with the view of a contemporary Muslim scholar, Dr Yusuf al-Qaradawi, who also suggests that donation should be the basis of the contract, if insurance is to be *Shari'a* compliant.

> In my view, insurance against hazards can be modified in a manner which would bring it closer to the Islamic principle by means of a contract of donation with a condition of compensation. The insured would donate his payments to the company with the stipulation that the company would compensate him, in the event that he is struck by calamity, with an amount which would assist him and reduce the burden of his loss. Such a type of transaction is allowed in some Islamic schools of jurisprudence.[4]

In view of the above, it is reasonable to conclude that the fundamental difference between *takaful* and insurance boils down to the fact that the premium must be paid on the basis of *tabarru'* (contribution).

In practice, all *takaful* operators in Malaysia clearly mention the term *tabarru'* in their proposal forms[5] as the basis for the payment of the premium (or contribution). By agreeing to *tabarru'* or donate part of their contribution, participants in various *takaful* schemes agree to cooperate and be mutually responsible to help one another should a member suffer a defined loss.

This is in harmony with the definition of *takaful* in Section 2 of the Takaful Act 1984 which describes *takaful* as:

> a scheme based on brotherhood, solidarity and mutual assistance which provides for mutual financial aid and assistance to the participants in case of need whereby the participants mutually agree to contribute for that purpose.

From the above definition, it is clear that the basic aim of *takaful* is to provide mutual financial aid to participants who have contributed to a common pool called the *takaful* fund. Participants who suffer a loss that is defined in the policy (*Takaful* Certificate) are entitled to claim for financial aid from the *takaful* fund in a kind of co-operative scheme.

On the assumption that people are generally charitable and have the natural tendency to help fellow human beings in need of aid, *takaful* operators have ample opportunities to leverage on the *tabarru'* factor. If done innovatively, this could bring about a more positive attitude towards *takaful* in comparison with conventional insurance. First, let us consider how it is that *tabarru'* has the potential to solve a common criticism levied against conventional insurance relating to the intangible nature of the insurance product.

The intangibility of the insurance product

The concept of insurance is sometimes described as a social device where the fortunate many help the unfortunate few, as does *takaful*. However, unlike *takaful*, this spirit of mutual help is no longer apparent in the commercial insurance contract. The commercial insurance transaction today is based on a contract of exchange whereby customers pay the premium in exchange for a promise by the insurer to pay financial compensation should a loss as defined in the policy occur. The technical definition is:

> an agreement whereby one party, the Insurer, in return for a consideration, the premium, undertakes to pay to the other party, the Insured, a sum of money or its equivalent in kind on the happening of a specified event, which is contrary to the Insured's financial interest.[6]

However, it is fairly common to hear customers who did not suffer any loss, that is, the fortunate many, complain that they receive 'nothing' tangible from the transaction and have lost the premium to the insurer. From their perspective, only the unfortunate few receive tangible benefits in terms of compensation as the result of a claim. In other words, no exchange has taken place as far as the majority of those insured are concerned. The fact that insurance had given them security (in the form of a promise) is so intangible that many of them cannot appreciate its value. This criticism, although not quite correct, must still be respected as value or the lack thereof is judged (rightly or wrongly) from the perception of the customers.

Takaful on the other hand is not a contract of exchange. Instead of buying a promise based on an event that may or may not happen, *takaful* customers make a contribution to a common pool on the basis of *tabarru'* (donation), with the intention (*niah*) to participate in a mutual aid scheme. The feeling of 'getting nothing' if no claim occurs is less likely to arise. Instead, participants would derive satisfaction from having helped fellow members and at the same time feel grateful that no loss had befallen them.

The cooperative nature of *takaful* provides some opportunities for *takaful* operators to make the intangible more tangible, thereby achieving an even deeper and more meaningful relationship with customers (including the fortunate many) in comparison with conventional insurance. As an alternative to conventional insurance, *takaful* has the potential to provide greater satisfaction to customers who care for the wellbeing of fellow human beings.

Good deeds as a value proposition

Tabarru' or donation can be an attractive value proposition to people, provided the concept is properly explained at the outset. If this is done properly participants can appreciate the fact that their contribution would be used to help other participants who have suffered a loss as defined in the *takaful* contract. We see this from the example of how people of different faiths generously respond to calls for donations following an earthquake, hurricane, tsunami and the like. The difference is that in those incidences, the donations were collected only *after* the tragedy had occurred. Under the *takaful* concept however, contributions are collected in an orderly fashion *before* the occurrence of the tragedy.

This would be especially meaningful to Muslims who believe that helping those in need with the sincere intention of seeking the pleasure of Allah is deemed an act of piety in Islam. This spirit of helping one another is enjoined upon Muslims as can be seen from a number of Quranic verses and Hadith or sayings of the Prophet Mohammed (PBOH).

> Help one another in furthering virtue and God-consciousness (taqwa), and do not help one another in furthering evil and enmity. (Sura Al-Maidah verse 2)

> Verily a believer is one who can give security and protection to the life and property of mankind. (Hadith reported by Ibnu Majah)

The challenge to *takaful* practitioners is to make participants associate doing good deeds with the worldly act of buying *takaful*. In the following paragraphs it can be seen which other opportunities exist where *takaful* operators can endeavour to innovate.

More unconventional ideas for innovation

We often hear the slogan that 'life insurance is for the living', meaning that it is the living family members who would benefit from the life insurance cover perviously taken out by the deceased. However, for *takaful* versions of life insurance, it is not just the living that can benefit but also the deceased. This can be explained by the following.

Muslim customers derive spiritual benefits by leaving specific instructions on how the monetary proceeds from the *takaful* cover should be used in the event of his or her 'untimely' death. The following are examples.

- To help settle his or her debts, which can be of enormous value to the deceased, because Muslims believe that people who die with debts cannot go to paradise, no matter how pious or faithful they have been, until all debts are settled.
- To pay outstanding *zakat* (tithes), which are obligatory for Muslims with a certain level of wealth.
- To pay someone else to perform the *Hajj* on behalf of the deceased. Performing the *Hajj* is another obligation on Muslims who are able both physically as well as financially.
- To purchase property such as mosques, hospitals or schools for the purpose of *waqf*

(benevolence) or to do other good deeds such as helping orphans, feeding the poor and the like. Although not obligatory, these acts are highly commendable from the perspective not only of Muslims, but all non-Muslims as well.

The above examples demonstrate that with some unconventional creativity, *takaful* products can be designed to provide additional utility (value) to faithful Muslims. This is because of the belief that the deceased can derive benefits in the form of rewards in the hereafter. Thus, if conventional insurance can offer products from 'the cradle to the grave', then *takaful* operators can go beyond that by offering benefits, literally, from 'the cradle to the hereafter'.

There are therefore many opportunities to foster deeper relationships not only between the *takaful* operators and participants but more importantly between the participants themselves.

Having discussed above some opportunities to leverage on the spiritual aspects of *takaful*, we must also be mindful that not everybody would perceive them to be of value. Some would still prefer conventional insurance while others may be indifferent. Whatever their perceptions, a commercial enterprise must try to decipher what their targeted customers would value and, if viable, endeavour to fulfil it. In this respect, the following paragraph shows actual experience of how *takaful* has quite successfully collaborated with conventional bancassurance to provide potential customers with what they want, the freedom of choice.

Conclusion

In Malaysia, as in most developing economies, insurance is sold and not bought. This could be due to lack of awareness about the importance of insurance. For some Muslims, misunderstandings on religious grounds probably compound the situation. To some extent, this problem has been reduced with the introduction of *takaful* but much work has still to be done to educate the Muslim population on both the 'worldly' and 'spiritual' values of *takaful* and financial planning.

Achieving success in an open market like Malaysia depends very much on the ability to innovate and provide enhanced value propositions for consumers. However, innovation need not be limited to material benefits only. There are customers who would perceive spiritual benefits to be of value too. The key is to understand what the targeted customers consider to be of value from their perspective.

Although *Shari'a* compliance is obviously important to many Muslims customers, it is also clear that *takaful* operators are expected to offer much more. Merely mirroring the 'worldly' benefits offered by conventional insurers is no longer enough.

What Muslims, especially, can find attractive about *takaful* are the double benefits they receive. First, they receive an insurance solution comparable to that of conventional insurance, with the additional benefit that it is in compliance with the *Shari'a*. Secondly, they receive the benefit of doing good deeds, which can be a very powerful motivation factor to Muslims as they believe the benefits are very lucrative. As the Quran says:

> The parable of those who spend their substance in the way of Allah is that of a grain of corn: it groweth seven ears and each ear has a hundred grains. Allah giveth manifold increase to whom He pleaseth: and Allah careth for all and He knoweth all things. (Quran 2:261)

The expectations of non-Muslim customers have not been discussed in detail, but it should be stressed that, particularly in Malaysia, they are also important to *takaful* operators. Selling *takaful* on the basis of doing good deeds is attractive to people of all faiths, as people would by nature derive satisfaction knowing that their contributions would be used to help fellow participants who are less fortunate. In the global village that we live in today, people are becoming more conscious about ethics, transparency and justice, irrespective of their religious beliefs, and thus the universal values that are fundamental to the *takaful* operation are attractive.

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1 Companies licensed to do *takaful* business under the Takaful Act 1984 are known as *takaful* operators.

2 Bank Negara Malaysia (BNM) handles the supervision and regulation of the *takaful* industry under the Act.

3 *Badan Petugas Khas' Report* p. 19 paragraph 2.6.3.5.

4 Dr Yusuf al-Qaradawi, *The Lawful and the Prohibited in Islam*. English translation. (New Delhi, Islamic Book Service, 1982) p. 276.

5 One of the functions of a proposal form is to enable those who wish to join the *takaful* scheme to offer (*ijab*) themselves for inclusion. If the proposal is accepted (*qabul*) then a contract (*aqad*) has materialised.

6 From MII textbook 'Risk & Insurance' published by The Malaysian Insurance Institute, Kuala Lumpar, 1995.

Part IV

Legal, regulatory and operational issues

Chapter 14

Towards a viable unit-linked *takaful* industry: The legal challenges ahead

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Introduction

Much is said about the rapid pace by which the Islamic banking industry is growing and of the size of the industry. The *takaful* (or Islamic insurance) industry, an important pillar in the integration process of Islamic financial institutions into the international banking community, has contributed to such growth. However, a successful integration of *takaful* products into the international insurance industry will require that a number of challenges be tackled. This is particularly true in the context of the legal challenges associated with structuring and marketing unit-linked *takaful* products. This chapter seeks to analyse these legal challenges and addresses the need for multi-dimensional structuring efforts in which bankers, *Shari'a* consultants and lawyers should invest to facilitate the problems of developing innovative unit-linked *takaful* products. The chapter will also focus on several investment aspects of unit-linked products, hence extending beyond a discussion of the plain *takaful* structure or wrapper surrounding it. To this end, this chapter will also discuss the type of vehicles and instruments that can be utilised to structure *Shari'a* compliant *takaful* products and the various types of investment funds to which *takaful* plans can be linked.

What are unit-linked *takaful* products?

Generally speaking, unit-linked products are products the benefits of which are expressed in units and a unit price.[2] In fact, they are viewed by many as a mixture of insurance and mutual funds. The same logic applies in the context of *takaful* unit-linked products where the performance of the *takaful* plan reflects that of the underlying investment fund or plan.

Though deemed by many as simple and straight forward, it is important to note that any *takaful* unit-linked product is subject to a myriad of variables, such as the nature of the underlying assets, the structure of the product, the risk profile of the customer and the experience and performance of both the investment manager of the underlying fund and the manager of the *takaful* product itself. Moreover, it is critical to highlight that, given the guidelines underpinning the Islamic banking industry, there is a strong possibility that a unit-linked *takaful* product may offer sufficient transparency to satisfy the disclosure requirements of the jurisdiction in which it is offered, yet fail to satisfy the level of disclosure required under *Shari'a* rules.[3]

Structuring *Shari'a* compliant investment funds

Shari'a compliant investment funds range from relatively straightforward long-only equity funds to the more challenging private equity, venture capital and short-only funds. In addition, industry players are actively seeking to introduce various types of *Shari'a* compliant funds of funds. Such funds of funds, though yet to be linked to *takaful* products on a wide scale, promise to minimise risk while diversifying holdings and outsourcing the allocation process to experienced funds of funds managers.

In many ways, a *Shari'a* compliant fund is akin to a conventional fund in terms of the legal structure, although the investment guidelines and policies of a *Shari'a* compliant fund are broader in that they incorporate a greater range of *Shari'a*-specific investment criteria. Structures implemented by promoters of Islamic funds mirror those familiar to Western bankers and investors particularly in respect of two considerations. First, the international banking institutions' desire to expand the suite of products they offer to include *Shari'a* compliant products. Secondly, the Islamic banks' focus on improving quality and seeking access to investors in heavily regulated jurisdictions.

The structuring phase of a unit-linked *takaful* product is arguably the most crucial as deciding on an appropriate *Shari'a* compliant investment structure for a unit-linked *takaful* product requires an analysis of issues of both substance and form. From a substantive point of view, investment managers and their legal advisers must consider the structure of the product, its investment objectives, regulatory compliance considerations and selling securities restrictions. Form is also significant under *Shari'a* because certain documentary, timing and mechanical requirements must be adhered to in order for an investment or finance structure to be declared *Shari'a* compliant.[4] By way of an example, in the context of an Islamic *ijarah* (lease) fund, it is imperative for the purchase of the assets to be concluded, with certain formal and mechanical requirements being satisfied, before the lease-back portion is introduced and implemented. For example, Islamic law does not permit a binding future sale or option to be incorporated into the lease contract. Such a sale would have to be concluded at the end of the lease by way of a stand-alone legal document, even if the intention of the parties from the outset is for such future sale or option to constitute an integral part of their arrangement.[5] Moreover, and notwithstanding the importance of form in structuring *Shari'a* compliant products, it is essential to emphasise that Islamic law is the arbiter of not only legal and technical compliance, but also of virtue and vice. The legal implication of this is that establishing structures that have no purpose other than to circumvent the requirements of the *Shari'a* is not permissible. Therefore, great care must be taken in structuring investment vehicles to ensure that they fundamentally operate in compliance with *Shari'a* precepts.

The role of financial institutions and fund promoters

The analysis of the legal implications of *Shari'a* compliant investment products should start with the identification of the financial institutions that are permitted to offer Islamic investment products. There are critical due diligence aspects that *takaful* companies should investigate thoroughly.

From a *Shari'a* point of view, it is generally agreed that both Islamic and conventional financial institutions are permitted to offer and manage Islamic investment products subject

to regulatory requirements. By the same logic, a non-Islamic bank or a non-Muslim can engage in trading or investing in a *Shari'a* compliant manner. A Western financial institution, for example, can therefore develop financial products that cater to the needs of its Muslim customers anywhere in the world. In many instances, this does not require the formation of an independent subsidiary, but rather, a separate department within an institution may develop and offer *Shari'a* compliant products. Despite this flexibility, the banking laws of a number of jurisdictions, particularly in Islamic countries, provide for two parallel licences, Islamic and conventional, with a different set of rules governing each.

Managers of unit-linked *takaful* products should develop both a generalised understanding of Islamic law and a working knowledge of the regulatory system in force in the jurisdiction where the investment vehicle will be structured and where the product will be offered.

The role of legal and *Shari'a* advisers

The decision by a financial institution to structure an Islamic product requires the early engagement of legal counsel and *Shari'a* advisers. The financial advisers should work with legal and *Shari'a* advisers to fine-tune their product ideas and vehicle structures in order to ensure full legal and *Shari'a* compliance. Legal advisers in particular must possess a good understanding of Islamic law to be able to advise on methods by which legal issues can be addressed in compliance with the requirements of the *Shari'a*, thus allowing them to communicate in a positive and constructive manner with *Shari'a* advisers.

Shari'a advisers represent differing schools of Islamic jurisprudence, although many of them are knowledgeable in the teachings of the key schools. While non-Islamic financial institutions often rely on recommendations made by their legal counsels or experienced counterparties in selecting *Shari'a* advisers on a product-by-product basis, Islamic financial institutions retain *Shari'a* advisers and form their own *Shari'a* supervisory boards that advise on and provide *Shari'a* auditing with respect to all investment products offered by such institutions. The mandate given by promoters of Islamic investment instruments to *Shari'a* advisers includes assisting in the development of a suitable structure for the proposed investment product, reviewing documentation, issuing a *Shari'a* compliance certificate and providing ongoing supervision (also known as a *Shari'a* audit) to ensure that the implementation of the structure is *Shari'a* compliant. In order to reach a high level of comfort that the underlying investment funds are *Shari'a*-complaint, *Shari'a* supervisory boards representing *takaful* companies often require that they have direct contact with *Shari'a* advisers representing the investment funds.

Domiciling an investment vehicle in a particular jurisdiction will necessarily require that the regulatory and tax regimes in such jurisdiction can accommodate the proposed Islamic structure. For example, an Islamic structure that involves multiple asset transfers is likely to prove to be expensive in a jurisdiction that imposes taxation on each asset transfer.

Such specialised legal advice is also necessary in view of a number of recent judicial precedents and rulings issued by English courts and by judicial bodies in various Gulf Cooperation Council (GCC) jurisdictions, adding another layer of analysis that practitioners and fund promoters must not neglect. For example, in a recent ruling by the English High Court on a case related to a *murabaha* transaction, the court decided that despite a choice of

law provision in the relevant *murabaha* agreement, which provided that the governing law of the contract should be English law 'subject to the principles of glorious *Shari'a*', English law would take precedence.

Jurisdictional requirements

Promoters of successful unit-linked *takaful* products must have a good level of understanding of the special attributes of the jurisdictions where the underlying investment funds are based. For example, a primary reason for the trend towards setting up Islamic funds in tax-friendly common law jurisdictions stems from a number of reasons including track record and their advanced trust systems, which offer protection for the investors' beneficiary ownership over the assets of the fund. Following suit, jurisdictions such as Bahrain and the Dubai International Financial Centre have recently passed advanced trust regulations.

Additionally, jurisdictions vary on their know-your-customer and other compliance requirements. A number of offshore jurisdictions have enacted and implemented the strictest compliance policies, such as Luxembourg and Dublin, although increasingly a growing number of Middle East jurisdictions are passing strict regulations as well.

In recent years, promoters of investment funds and products, including unit-linked *takaful* products, have turned their attention to jurisdictions such as Bahrain and Malaysia, which offer detailed regulations applying to the set-up of collective investment schemes, both conventional and Islamic, tax-friendly environments, and increasingly strict compliance policies. Other jurisdictions are in the process of enacting regulations that apply to the set-up of collective investment schemes and other investment structures.

Notwithstanding the foregoing, both as a matter of *Shari'a* and legal compliance, the risk factors and investment guidelines associated with a unit-linked product should be clearly and sufficiently described in the offering documents of the product. Risk factors often include investment, liquidity of shares, forfeiture, country-specific factors, corporate disclosure standards, the political climate, currency, foreign investment considerations and, in the context of *Shari'a* compliant investment funds, *Shari'a* compliance risks. Additionally, *Shari'a* compliant investment funds are subject to the same, or arguably a higher, degree of compliance, risk and suitability analysis, and scrutiny than conventional investment funds given the emphasis of the *Shari'a* on full and accurate disclosure.

Forms of Islamic investment funds

Long-only equity funds

In an Islamic long-only equity fund, amounts raised from investors are invested in shares of listed companies, provided that such companies have been declared to be *Shari'a* compliant. The companies in whose shares investment is permitted may be identified as *Shari'a* compliant by reference to their inclusion in 'Islamic' indices such as the Dow Jones Islamic Market Index or the TII-FTSE Islamic Index. The companies included in such indices will have been declared *Shari'a* compliant by the indices' respective *Shari'a* advisers. Otherwise, the

compliance of a company with *Shari'a*, and thus the permissibility of its shares as an investment for the fund, will be verified and audited by the respective fund's *Shari'a* supervisory board.

The investment manager to an Islamic long-only equity fund can act as a *mudarib* (sweat partner) under a mudaraba arrangement, a *wakeel* (agent) under a *wakala* arrangement, or an investment manager pursuant to an investment management agreement. The investment managers, *wakeels* or *mudaribs*, as the case may be, usually adhere to pre-defined investment guidelines that set out the industries in which the fund may invest and the financial ratios it must maintain. The role of *wakeels* or *mudaribs* in the context of an Islamic fund should be distinguished from the *wakeels* or *mudaribs* who manage the unit-linked *takaful* product itself.

The ongoing *Shari'a* compliance of the fund should be subject to a regular (annual or semi-annual) audit by the *Shari'a* supervisory board, although external accounting firms also can be appointed to audit the fund's compliance with its investment guidelines.

Capital-protected funds

The *Shari'a* prohibits the generation of income by way of interest. This is primarily due to the fact that the *Shari'a* requires that any return on funds invested by an investor, or lent by a lender, be the outcome of a commercial transaction in which the investor or the lender risks its capital. Thus, capital-guaranteed funds and investments are not *Shari'a* compliant. The alternative is a fund or an instrument that offers capital protection without guaranteeing the capital.

Most *Shari'a* compliant capital-protected funds utilise two investment mechanisms to achieve the required investment objective:

- a *murabaha* instrument, which involves the investment of the bulk of the monies raised from investors in a fixed-term commodity trade transaction or a series of such transactions; and
- a *bai' al-arboon* (a *Shari'a* alternative to a call option) transaction, based on which the fund invests a small percentage (for example 10 per cent) of the monies raised from investors to purchase an option over a basket or portfolio of *Shari'a* compliant shares or commodities. *Murabaha* transactions, which are customarily viewed as low investment risk transactions, are structured to generate the required capital protection component, while *bai' al-arboon* transactions are intended to increase returns. If the basket of shares subject to the *bai' al-arboon* depreciates, the fund manager will not exercise the option and the payment price for the option will have been lost. *Murabaha* transactions, however, are structured to compensate for the lost option payment, hence protecting, but not guaranteeing, the capital.

Venture capital funds

With the *Shari'a* encouraging risk-taking and prohibiting interest, unleveraged venture capital (VC) funds are ideal tools for making investments in an Islamically-compliant manner. A sponsor of the venture capital fund can act as a *mudarib* under a mudaraba arrangement, a *wakeel* under a *wakala* (agency) arrangement, or an investment manager pursuant to an investment management agreement.

A number of conventional venture capital funds have passed *Shari'a* compliance tests with only minor adjustments being made to the offering document and ancillary agreements. In each case a *Shari'a* supervisory board was appointed and detailed *Shari'a* compliance criteria were introduced and implemented.

While risky in nature, *Shari'a* compliant small cap or VC funds may, at least technically, be linked to a *takaful* product, provided that the risk factors are fully disclosed to the investors.

Private equity funds

The discussion becomes more complex in the context of private equity funds, particularly those that utilise leverage to purchase a controlling stake in a target company or that invest in leveraged target companies. Generally, Islamic private equity funds are only available to high net-worth and institutional investors who can assess the risks associated with investing in such funds. Having said this, some private equity funds may seek to invest in pre-IPO opportunities and as such may be available to high net-worth and sophisticated *takaful*-plan holders.

An Islamic private equity fund must finance the acquisition of a target company by using *Shari'a*-approved mechanisms. In addition, the leverage of the target itself is often relevant. Different schools of Islamic jurisprudence have different views on the subject. Some *Shari'a* advisers are of the opinion that if an Islamic private equity fund were to purchase a controlling stake in a leveraged company, then such a fund would be given a fixed period of time (perhaps three years) to pay off the target company's debt or convert it into Islamically-acceptable debt. Another view prohibits the acquisition of target companies if their debt exceeds one-third of the total capital of the target company. In such cases, debt should be reduced to one-third of the total capital of the target company prior to the acquisition being approved. In any case, the activities of the target company should be *Shari'a* approved. Therefore, investing in companies that are involved in industries such as gambling, conventional banking and insurance, arms manufacturing and alcohol is strictly prohibited.

Finally, issues such as the nature of the debt (Islamic or non-Islamic) and the manner in which the total capital of the target company is calculated can be troublesome.

Leasing (*ijarah*) funds

Ijarah funds are often described as lease-finance vehicles, but there are some substantive differences between a lease in the conventional sense and an *ijarah*. In an Islamic *ijarah* fund, the fund purchases the assets (normally equipment, real estate and, in some instances, fixtures such as power generators) and leases them to the lessee. The agreed rent paid by the lessee to the fund, as lessor, is calculated such that an agreed profit element is built into the rent payment. An *ijarah* differs from a conventional lease in that Islamic law does not permit that a binding future sale or option be incorporated into the lease contract for the disposal of the residual value of the leased assets at the end of the lease term. The *Shari'a* equivalent of lease-to-own transactions are *ijarah-wa-iktina'a* arrangements, in which lease payments are payable to a special account and are then used to make the final payment for the leased asset, hence transferring ownership over such leased asset to the lessee on the expiration of the lease term and satisfaction of the terms of the lease agreement.

Additionally, developing a floating-rate lease under Islamic law is more problematic than a conventional lease. This is mainly due to the fact that the *Shari'a* requires that a single rent amount must apply throughout the life of the lease.

Leasing funds that invest Islamically in *Shari'a* compliant assets can be linked to a *takaful* product and are likely to be offered, in the near future, to high net-worth and sophisticated *takaful*-plan holders.

Hedge funds and other alternative investments

The Islamic asset management industry is expanding into new frontiers encompassing hedge funds and other types of alternative investments. Many financial-industry professionals are currently involved in the development of *Shari'a* compliant alternatives to most of the conventional investment vehicles and products available in Western markets. The debate continues as to whether the most recent attempts to develop *Shari'a* compliant hedge funds have been successful both in terms of structuring and, most visibly, marketing.[6] One thing is certain – the Islamic hedge funds industry is yet to live up to its potential. Despite the foregoing, the mere focus on, and debate with respect to, such products represents a notable shift in the sphere of Islamic banking. One may argue that developing a successful Islamic hedge is an undertaking of such magnitude that it tests the level of the industry's commitment to developing innovative Islamic products. The process requires close interaction among bankers, prime brokers, *Shari'a* advisors, economists and lawyers. More importantly, a prerequisite is a thorough understanding of the manner in which conventional hedge funds function. Therefore, *Shari'a* advisors with a background in economics are well suited to participate in developing this industry.

As hedge funds take various forms, the most challenging task involves developing a workable alternative to short selling. Islamic shorts seem to be either *salam*-based (a future sale equivalent) or *arboun*-based (a call option equivalent). In addition, it is important to keep in mind that a successful Islamic short sale may need to be supplemented by such instruments as *murabaha* to address the liquidity needs of the product and *wakala* to introduce credible third-party intermediaries to the arrangement.

Apart from Islamic hedge funds, derivatives are believed to constitute the final frontier that the Islamic banking industry will need to tackle. Its status as the final frontier stems from the various types of derivative products currently available in the market and the degree of innovation that is invested in developing each, which may lead to uncertainty and the excessive use of interest-bearing instruments.

The suitability of the above products in the context of unit-linked *takaful* products is yet to be seen. We may be some years away from the day on which a market-neutral fund, for example, is successfully linked to a *takaful* product. The process has commenced and some pioneers have been successful in developing hedge funds. Once these products are successfully marketed to a wider audience, albeit one that is qualified to assess the risk associated with investing in such products, it will only be a matter of time before *takaful* providers expand their suite of funds to include alternative investment funds.

The discussion above should be read against the back-drop of certain opinions made by some of the world's leading *Shari'a* scholars that Islamic banks should not seek to 'introduce

Islamic variants of each and every conventional instrument'[7] and that derivatives, generally, are not *Shari'a* compliant. It is not clear whether the scholars are discouraging the Islamisation of conventional products, including the processes implemented in achieving them, or if such discouragement extends to the development of Islamic mechanisms that achieve similar economic results while utilising innovative processes in doing so. A discouragement of the latter can be attributed to the high degree of risks generally associated with investing in derivatives. It is important in any case for the industry to seek guidance from *Shari'a* scholars and work closely with them in working out suitable structures.

Advanced forms of unit-linked products

Takaful companies seeking to promote unit-linked *takaful* products to customers and investors in the European Union (EU) markets may utilise internal funds or equity certificates. A European *takaful* company may offer Islamic investors the opportunity to invest in *Shari'a* compliant investment plans, even if such plans are not registered in the EU, through the sale of units in an internal fund of the *takaful* company that mimics the performance of the original investment fund through applying similar investment guidelines and policies. Alternatively, the original investment fund can be embedded in the respective *takaful* products offered by the *takaful* company.

Another alternative is for the *takaful* company to issue Islamic equity certificates. Such certificates would mirror the performance of an underlying portfolio thereby allowing the Islamic investor to participate in the gains or losses of the relevant portfolio. The certificates can also be listed on a major European stock exchange. The first of such certificates are believed to be 'The Islamic Equity Builder Certificates', developed and promoted jointly between The National Commercial Bank and Deutsche Bank, and listed on the Frankfurt stock exchange.

Restrictions in the offering of securities

Takaful companies seeking to market unit-linked products should comply with the insurance (or *takaful* in some jurisdictions) and securities regulations in force in the jurisdiction where the products are offered. For example, *takaful* companies and managers should be cognizant of the fact that the EU allows promoters of Islamic funds the opportunity to access a growing and relatively wealthy Muslim community. A promoter of an Islamic fund planning to market its fund in one or more of the EU member states must first obtain a certificate (also commonly referred to as a European Passport) in compliance with EU Council Directive of 20 December 1985 on the Coordination of Laws, Regulations and Administrative Provisions relating to Undertakings for Collective Investment in Transferable Securities (the 'UCITS Directive'). Member states must apply the foregoing UCITS Directive to undertakings for collective investment in transferable securities (UCITS) within their territories. Accordingly, no unit trust can carry on activities as such unless it has been authorised to do so by the competent authorities of the member state in which it is situated. Such authorisation would then be valid for all member states. A unit trust can be authorised only if the competent authorities have approved the management company, the fund rules and choice of depositary. The UCITS Directive

provides for detailed conditions which apply to the taking-up of business, relations with third parties, operations, investment policies and the taking of deposits.[8]

In the United States, generally speaking, entities undertaking investment management activities are required to comply with the requirements of the United States Investment Company Act of 1940, as amended. The Act governs the registration and activities of investment companies. To avoid the application of the Act, entities undertaking investment management activities in the United States should monitor their activities to ensure that either the Act does not apply or that specific exemptions are available.

Separately, the offer and sale of units of an investment fund, or other securities, in the United States must be registered under the US Securities Act of 1933 (the 'Securities Act'). To avoid this requirement, transactions can be structured to take advantage of the safe harbours from registration provided by Rule 144A or Regulation S.

Conclusion

Many agree that there is a long way to go before Muslim investors have equivalent knowledge and access to efficiently-structured and competitively-priced insurance products as do investors in jurisdictions where the insurance and unit-linked products industry is more advanced.[9] As the Islamic banking industry expands into Western markets, *takaful* products may prove to be a reliable test case for the coexistence of *Shari'a* compliant products alongside conventional investment vehicles. The legal challenges facing the integration process, including the need to educate Muslim investors about the advantages of *takaful* unit-linked products, and the process of structuring and marketing unit-linked *takaful* products, will demand a multi-dimensional and innovative approach among all the parties involved.[10] If the combination of *Shari'a* compliance and the regulation of the Western markets fails to stifle such innovation, the alternative investment vehicles and advanced forms of unit-linked products discussed in this chapter may attest to a bright future for an untapped market of wealthy Islamic investors in the West.

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1 The writer acknowledges the assistance of Tricia Boutros of the firm's Dallas office in the preparation of this chapter.

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3 '2005 Global *Takaful* Review: Evolving Trends, Opportunities and Challenges', Sohail Jaffer, www.Islamicfinancenews.com.

4 Ayman H. Abdel-Khaleq 'Legal Implications of Structuring and Offering *Shari'a* Compliant Investment Products', in *Islamic Asset Management – Forming the Future for Shari'a Compliant Investment Strategies*, Sohail Jaffer (ed.) (London, Euromoney Books, 2004).

5 *Ibid.*

6 Professor Humayon Dar, '*Shari'a* Issuer with Hedge Funds', *Islamic Business and Finance* (September 2006).

7 Interview with Sheikh Muhammed Taqi Usmani, *Islamic Business and Finance* (September 2006).

8 Ayman H. Abdel-Khaleq, 'Offering Islamic Funds in the US and Europe', *International Financial Law Review* (May 2004).

9 James Hume, 'Role of Development Policies in Strengthening the *Takaful* Industry', in *Islamic Asset Management – Forming the Future for Shari'a Compliant Investment Strategies*, Sohail Jaffer (ed.) (London, Euromoney Books, 2004).

10 *Ibid.*

Chapter 15

Operating and financial performance characteristics of *takaful* operators: a snapshot in 2006

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Introduction

The global *takaful* segment of the insurance industry is 27 years old (versus conventional mutuals that are over 300 years old) and is rapidly emerging as a risk mechanism with which to be reckoned. Although definitive data is unavailable, research indicates there are at least 72 dedicated *takaful* operators and *takaful* 'windows' operated through conventional insurers worldwide. Demand for *takaful* cover is growing in many countries at over 30 per cent annualised growth rate. Three of the Organisation of the Islamic Conference (OIC) countries (Sudan, Malaysia and Bahrain) have promulgated distinct and independent *takaful* regulatory frameworks. Two fully-fledged family (life) *takaful* operators are flourishing. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has recognised and issued three accounting/auditing standards specifically for *takaful* operators. Focus on retail products and services results in nearly 60 per cent of *takaful* revenues from automotive and personal lines cover. Although three to four new risk pools with combined paid-up capital at US$250m were created in 2005, there remains a shortfall in re-*takaful* capacity to support the rapid growth in primary *takaful* insurance. In addition, multinational insurers such as HSBC, AIG, Axa and Prudential have embraced *takaful* and are entering the global industry in multi-markets.

The current *takaful* landscape

While the *takaful* market is building momentum and exhibiting impressive growth globally, there are several fundamental hurdles standing in the way of it realising its full potential in the near term. Among the most important roadblocks are the following.

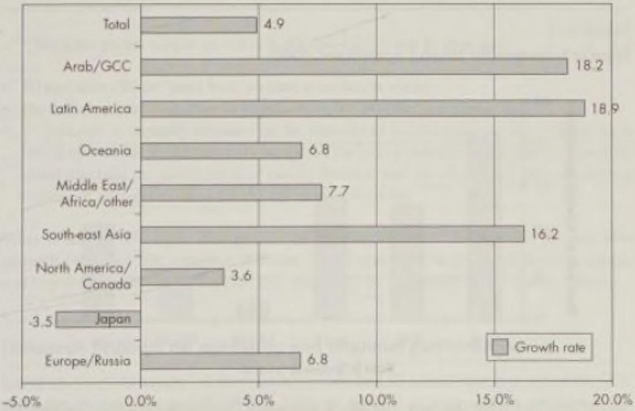
- The lack of an insurance regulatory framework that specialises in *takaful* supervision (only three OIC countries have *takaful* rules) results in a majority of *takaful* operators being monitored in a manner identical to their conventional counterparts.
- There is a lack of trained insurance staff with which to propel the insurance industry forward – approximately 6,000 insurance staff exist across the Gulf Cooperation Council (GCC) region (versus 84,000 agents in Malaysia alone).

- There is an absence of 'benchmarks' and standards for judging excellence in *takaful* operations.
- There is an absence of guidelines and prudential rules for insurance investments into Islamic securities.
- There is a scarcity of sophisticated, state-of-the-art software and technology platforms to operate insurance/*takaful* programmes – fully web-enabled, permitting multiple 'touch points' for customers.
- No *takaful* operator has yet earned an 'A' financial (or claims-paying) rating.
- Re-*takaful* capacity is constrained – currently representing some 14 per cent of primary *takaful* gross contribution written annually.

Many published articles describe the low penetration rates across the Arab world for insurance which in aggregate represents only 20 per cent of the total insurance written in South-east Asian markets and only 4 per cent of that in Europe and Russian markets. As of 2006, Arab world gross premiums were only 1 per cent of worldwide gross premiums of US$3.4tn. Conversely, many observe that the high growth rates in the Arab world (collectively 7.7 per cent – although the GCC submarket is expanding at 18 per cent per annum) represent a very attractive emerging market. However, when compared with growth rates in Latin America

Exhibit 15.1

Annualized growth rates for insurance, 2005



Source: Author's own

(19 per cent per annum), Europe and Russia (7 per cent per annum) and South-east Asia (16 per cent per annum), there may arise perceptions that additional resources and capital are better deployed into faster-growing markets that display fewer political risks. Exhibit 15.1 illustrates this.

Thus, one main challenge to *takaful* operators in evolving into the next cycle of development is how to attract partnerships with, and technical assistance from, leading insurance providers whose attention could be diverted to opportunities elsewhere.

A snapshot of the *takaful* industry: Time in business and modalities

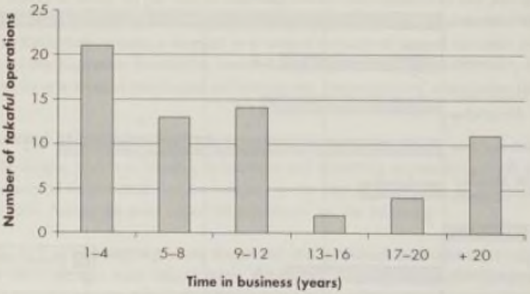
The re-discovery of *takaful* mechanisms for risk sharing is a recent phenomenon. In fact, since 1979, 53 per cent of *takaful* operators have been in business less than eight years. Only 10 (17 per cent) are older than 20 years (see Exhibit 15.2).

Moreover as *takaful* operators have sprung up under differing legal and *Shari'a* regulatory regimes (Sudan versus Asia/Malaysia versus the Middle East/Saudi Arabia), there is a fairly wide array of *takaful* models, and not yet enough time for convergence around a harmonised model.

In fact, out of a sample of 69 *takaful* operators, some 48 (70 per cent) are pure *takaful*, while the remainder are a blend of re-*takaful*/*takaful*, cooperatives and those based on other models.

Exhibit 15.2

Time in business for *takaful* operations, 2005



Source: Omar Clark Fisher, Operating and Financial Performance Characteristics of *Takaful* Operators in GCC (unpublished PhD thesis, as submitted to the International Islamic University of Malaysia and Camden University of Delaware, United States of America, November 2005)

Exhibit 15.3

Modes of risk sharing, 2005

Source: Omar Clark Fisher, Operating and Financial Performance Characteristics of *Takaful* Operators in GCC (unpublished PhD thesis, as submitted to the International Islamic University of Malaysia and Camden University of Delaware, United States of America, November 2005)

From the global sample provided in Exhibit 15.3, it can be seen that:

- 20 operators (29 per cent) have adopted a mudaraba model;
- the *wakala* model is gaining in popularity in the Middle East region; and
- no firm data is currently available on the majority of *takaful* operators (40 of them) as to which operational model they have adopted. This lack of transparency regarding modalities could constrain the proliferation of *takaful* business and the adoption of best practices as evidenced amongst existing *takaful* operators worldwide.

What is known now about best practice in the *takaful* sector? Regrettably, there is little research published that compares different *takaful* operators, or compares between *takaful* and conventional insurers. However, one study may be referenced, as we discuss below.

Research findings on operating and financial performance

Based upon a study sample[3] of 69 companies, including 15 *takaful* operators across the GCC states for the five-year period 1999 to 2003, an analysis of their relative operational and financial performance characteristics when compared with conventional insurance companies yields the following four seminal observations.

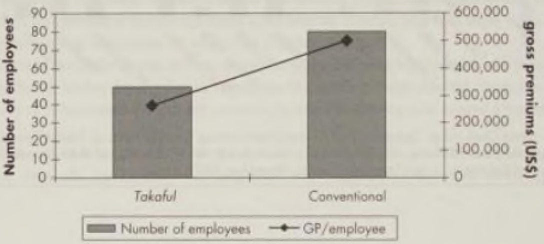
Staffing and productivity

Takaful companies average 99 employees versus an average of 93 for conventional insurers. (The *takaful* median is 50 versus a median of 80 for conventional insurance providers.)

The average productivity per employee (gross premiums written per employee) is US$263,000 per annum versus an average of US$500,000 per annum for those of conventional insurers. Exhibit 15.4 illustrates this.

Exhibit 15.4

Productivity of *takaful* operators versus that of conventional insurers (GCC)



Source: Omar Clark Fisher, Operating and Financial Performance Characteristics of *Takaful* Operators in GCC (unpublished PhD thesis, as submitted to the International Islamic University of Malaysia and Camden University of Delaware, United States of America, November 2005)

While *takaful* operators in the GCC seem to have approximately similar staffing on average as conventional insurers, the median number is about one third less, which most likely results from their being newer businesses. However, *takaful* operators are not as productive per employee in generating gross premiums – in fact *takaful* productivity is only one-half that of their conventional counterparts.

Assets and net income

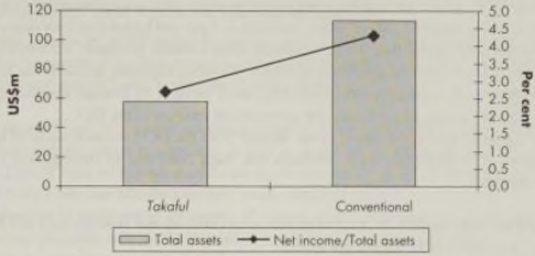
The average total assets of *takaful* companies is US$58m versus an average of US$113m for conventional insurers. (*Takaful* operators' median assets are US$17m versus a conventional median of US$64m.)

Takaful average net income over total assets is 2.7 per cent versus conventional net income of 4.3 per cent. (*Takaful* operators' median net income over total assets is 2.9 per cent versus conventional operators' median of 4.2 per cent.) This is illustrated in Exhibit 15.5.

Takaful operators possess average total assets that are roughly one-half the size of those of conventional insurers and about one-quarter the size on a median basis, which means that

Exhibit 15.5

Takaful operators versus conventional insurers total a ssets and net income (GCC)



Source: Omar Clark Fisher, Operating and Financial Performance Characteristics of *Takaful* Operators in GCC (unpublished PhD thesis, as submitted to the International Islamic University of Malaysia and Camden University of Delaware, United States of America, November 2005)

one or two larger *takaful* operators could be skewing the average calculation somewhat higher than the median figure. *Takaful* average net income over total assets is one-third less than that of conventional insurance companies, which seems to imply that *takaful* operators are not yet as efficient in operations nor in deployment of assets as conventional insurance companies.

Volume of premiums and retention

Takaful companies' average gross written premiums (GP) annually are US$36m versus an average of US$41m for conventional insurers. (The *takaful* median GP is US$8m versus conventional insurance median GP of US$26m.)

Takaful operators' average retention of GP is 58 per cent versus an average of 46 per cent for conventional insurers. (The *takaful* median retention of GP is 56 per cent versus conventional insurers at 41 per cent.)

Takaful operators annually write only 12 per cent less gross premiums on average than conventional companies, which suggests that *takaful* can attract retail clients on a par with conventional insurers. However, when using the median figures, this means that *takaful* operators are only generating one-third the gross premiums annually as their conventional counterparts. Assuming that both types of insurers have at least the same paid-up minimum capital required for an insurance license, then *takaful* operators are less efficient in deploying that risk capital and consequently have lower profitability. However, *takaful* operators have a marginally higher retention rate of business written, probably due to the high concentration in automotive business where risk retention of upwards of 60 per cent is quite common.

Operational efficiency

Takaful operators' average combined ratio is 82 per cent versus an average of 77 per cent for conventional insurers.

Takaful operators' average shareholder return on equity (ROE) is 13.1 per cent versus an average ROE of 18.2 per cent for conventional insurers. This is illustrated in Exhibit 15.6.

The average combined ratio of *takaful* operators is 7 per cent higher than their conventional counterparts, which means that *takaful* operators, while certainly profitable, are less profitable on average. This is most probably due to higher operating expenses and/or lower levels of gross premiums. As a consequence, *takaful* operators produce an average shareholder ROE of 13.1 per cent versus 18.2 per cent for conventional insurers in the GCC.

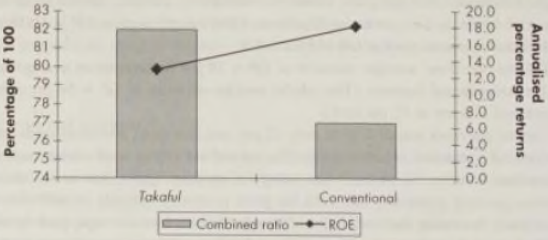
In summary, from these observations derived from the GCC research study of the five year period 1999–2003, one could conclude that when compared to conventional insurers *takaful* operators:

- are staffed with one-half the number of personnel (median) and generate only one-half the gross premiums per employee per annum;
- hold one-half the total assets (on average) and yield one-third less net income on those total assets; and
- write only one-third of the gross premiums (median) as conventional insurers with a higher combined ratio that leads to a lower ROE to shareholders (13 per cent versus 18 per cent, on average).

It would be extremely advantageous for a *takaful* association or other body to complete in-depth research into the factors leading to 'successful' *takaful* operations, in particular the

Exhibit 15.6

Combined ratio and ROE: *Takaful* operators versus conventional insurers (GCC)



Source: Omar Clark Fisher, Operating and Financial Performance Characteristics of *Takaful* Operators in GCC (unpublished PhD thesis, as submitted to the International Islamic University of Malaysia and Camden University of Delaware, United States of America, November 2005)

elements of efficiency, effectiveness, financial returns and spiritual rewards. Once identified, aspiring *takaful* companies might emulate such successful factors for the mutual benefit of policyholders and shareholders.

The suggested next cycle for *takaful* development

To further accelerate growth across the *takaful* sector, there are several major initiatives that could form an agenda for action among *takaful* operators, together with support from insurance regulators and central banks worldwide. Among these are:

- the establishment of a global *takaful* association to network, share research and analysis of risks and mitigation mechanisms as well as operating results of industry players (note that Central Bank of Bahrain established the International Takaful Association in late 2006 as a bridge between Middle East and Asian *takaful* operators);
- a campaign to build public awareness of virtues of risk protection in general and *takaful* cover in particular as a viable alternative to existing insurance offerings;
- programmes to redress a general absence of personal financial planning, from couple savings and insurance plans to household wealth management plans, for the general public;
- the encouragement of cross-fertilisation between *takaful* operators through the professional associations of sales, underwriters, actuaries and other insurance personnel to assure delivery of high-quality services and enhance public trust in such services;
- to enrich and expand the current limited offerings of Islamic securities suitable for insurance and *takaful* investments; and
- the collaboration with insurance regulators to develop benchmarks for excellence, globally and in key markets, to ensure reliable data on *takaful* operations and to shape guidance for regulators, together with measurement tools to gauge good from excellent *takaful* operations.

Conclusion

The *takaful* industry is a young, emerging segment of the worldwide insurance industry, representing less than 1 per cent of worldwide gross written premiums in 2006. Yet the latent demand from the Muslim communities across the globe (which are 20 per cent of the world's population) for a religiously-acceptable alternative to conventional insurance has been proven by the remarkable annual growth rates of over 30 per cent in Malaysia, Sri Lanka, Indonesia and Qatar. This certainly ensures that the *takaful* business is not a passing phenomenon. However, insurance is a technical, actuarial-driven business where the market leaders excel in operating efficiencies, controlling costs and introducing new products consonant with customers' changing needs.

As the research study described in this chapter shows from a sample of *takaful* operators in the GCC, there are important challenges confronting *takaful*, for competition is heating up in the Middle East from local established conventional players as well as from international insurance brands seeking to gain market share in the robust GCC economies. Offering an Islamic-alternative cover is no longer sufficient to win over customers – *takaful* operators

must now strive to outperform the industry averages, to re-define and deliver superior quality customer services and to exceed benchmarks for excellence amongst mutual/cooperative insurers. As in other financial services sectors worldwide, those *takaful* operators which cannot meet or beat such benchmarks are likely to be eliminated by or merged into their stronger competitors.

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1 Omar Clark Fisher, *Operating and Financial Performance Characteristics of* Takaful *Operators in GCC* (unpublished PhD thesis, as submitted to the International Islamic University of Malaysia and Camden University of Delaware, United States of America, November 2005).

Chapter 16

Regulatory approaches to *takaful*

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Introduction

As can be seen from previous chapters, two main *takaful* models exist: the *wakala* and mudaraba models. The principal difference between the two is the role played by the *takaful* operator. Under the *wakala* model, the operator is the agent of the participants and is consequently entitled to a fee for the services provided. Such a fee is deducted from the participants' contributions into a general *takaful* fund or the investment profits derived from investing the general *takaful* fund, which may be performance related. The operator does not share in any underwriting surplus or profits, which will be distributed exclusively to the participants. Under the mudaraba model, on the other hand, the operator is entitled to a fixed percentage of any investment profits or any surplus, which is paid into the participants' *takaful* fund. The operator's fixed percentage is not guaranteed.

The regulation of *takaful* is still in its infancy in many jurisdictions, with some favouring the use of one model over another. Here we consider the salient features of the legal and regulatory approaches taken by four different jurisdictions: the United Kingdom, Bahrain, Malaysia, and Dubai.

The United Kingdom

In the United Kingdom (UK) the regulation of insurance is governed by the Financial Services and Markets Act 2000 (FSMA), which came into force in December 2001. FSMA provides that carrying on a regulated activity, or purporting to do so, in respect of a specified investment (which includes rights under a contract of insurance) by way of business in the UK requires authorisation by the Financial Services Authority (FSA), unless the person carrying on such activity is exempt (for example, that person is an appointed representative or a recognised investment exchange – section 19).

Regulatory activities include effecting or carrying out contracts of insurance.[1] The question of whether the business element is present will be a question of judgment, taking into account several factors, none of which is likely to be conclusive. It is worth noting, in respect of the geographical scope of FSMA, that, even though the *takaful* operator may not be based in the UK, it could still be carrying on business in the UK if, for example, it transacts business by making an occasional visit or phone call to the UK or it has established a website which is accessible from the UK.

As yet, the FSA has not faced an application to authorise a *takaful* operator, although Lloyd's was recently involved in the launch of the first syndicate to be managed in accordance with *Shari'a* principles. Therefore, at present, the FSA has said very little on the subject of *takaful*. That said, the FSA's policy to date towards the regulation of Islamic products has been summed up as 'no obstacles, no special favours'. The FSA has repeatedly indicated that it is keen to promote a level playing field between conventional and Islamic providers. In a recent briefing note published by the FSA, it was stressed that the FSA was intended to be a financial, not a religious, regulator. Accordingly, it would appear from this that the FSA intends to treat any application for authorisation from a *takaful* operator on the same basis as an application from a conventional insurer. In other words, unlike other jurisdictions, such as Bahrain, which has enacted separate regulations for *takaful*, the FSA does not appear to intend to follow suit. Rather, an application by a *takaful* operator will require to be dealt with in the same way as an application by a conventional insurer within the UK's existing insurance framework.

There is no statutory definition of a 'contract of insurance'. However, case law has identified the following essential elements:

- There must be a promise from the insurer to pay money (or money's worth) to the insured in the event that the insured suffers an insured loss.
- The insured must have an insurable interest (that is, a pecuniary interest) in the subject matter of the policy.
- What the insured purchases is the right to receive money (or money's worth) on the occurrence of an uncertain event (the key feature being that there must be an element of contingency, either as to the occurrence of the event or as to its timing).
- There must be a premium passing between the parties.

The consequence under English law of a contract being a 'contract of insurance' is that, unlike other contracts, it will be subject to the doctrine of 'utmost good faith'.[2] This doctrine imposes a duty of full disclosure on both parties to the insurance contract.[3] Although, as noted above, *takaful* does not involve the payment of a premium but the payment of a 'donation', it does not appear that any of the essential elements of an insurance contract (including the doctrine of utmost good faith) are inconsistent with the *Shari'a* principles governing *takaful*, and, consequently, it is likely that *takaful* will have all the essential hallmarks of an insurance contract for the purposes of English law.

The consequence of carrying on a regulated activity without being authorised is very serious. It is a criminal offence which is punishable by imprisonment for a term not exceeding two years and/or a fine (section 23). Furthermore, any agreement entered into by a person in contravention of the requirement to be authorised will be unenforceable against the other party, who will be able to recover any money or other property paid or transferred by him under the relevant agreement.

In these circumstances, the FSA will review any application from a *takaful* operator to ensure that the same criteria that must be met by conventional insurers are met by the *takaful* operator. An applicant for authorisation will be required to satisfy the FSA's risk assessment process, which involves an assessment of the risk posed by an applicant against a number of

probability and impact factors. The FSA carries out its risk assessment against its statutory objectives. These are:

- to maintain confidence in the financial system;
- to increase public understanding of the financial system; and
- to secure appropriate consumer protection and to reduce financial crime (section 2).

The risk assessment is a high-level desk-top review and involves identifying business and control risks as well as external risks. In addition, there are a number of threshold conditions that require to be satisfied which are considered below.

Conduct of business

The Insurance Conduct of Business (ICOB) rules seek to carry out the high-level obligations set out in the FSA's Principles for Businesses. Any applicant for authorisation needs to ensure compliance with both the Principles for Businesses and the ICOB rules. These principles impose obligations (amongst other things) to:

- observe proper standards of market conduct;
- observe high standards of integrity and deal with consumers fairly;
- act with due skill, care and diligence;
- maintain adequate resources to run the business in an orderly manner;
- ensure that appropriate management, systems and controls are in place in relation to the size and complexity of the operation;
- ensure transparency and deal with the FSA in an open and cooperative manner; and
- disclose to the FSA anything relating to the firm that the FSA would reasonably expect to be disclosed.

Capital adequacy

The *takaful* operator must have sufficient financial resources to meet claims as they fall due. In particular, there should be a solvency margin as determined and agreed with the FSA.[4] This margin represents the excess of assets over liabilities and provides a useful 'cushion' against any unexpected claims. Under the *wakala* and mudaraba models, initial capital adequacy concerns will need to be addressed, possibly through the shareholders of the *takaful* operator's paid-up capital, cash reserves or paid-up earnings.

In calculating the solvency margin, the rules relating to admissibility of assets need to be applied.[5] These rules prescribe how much of the value of an asset (if any) can be included in the calculation of the asset for the purpose of determining the solvency margin, taking into account the permitted exposure for an asset and the maximum exposure to particular counterparties. These rules are designed to encourage a sufficient spread of assets. Given that the scope for investment is more limited for *takaful* operators as a result of the present limited size of the Islamic investment market, care needs to be taken that technical solvency margins can be satisfied.

Management, systems and controls

The *takaful* operator must have adequate human resources. This means there must be competent and prudent management, which will be responsible for managing the various risks involved in the *takaful* operation (for example, legal risk, regulatory risk, underwriting risk, credit risk and liquidity risk). Also, those persons who occupy certain so-called 'controlled functions' must be 'fit and proper' (that is, they must be an 'approved person' which broadly requires them to be honest and have the appropriate level of competence and capability[6]). There must also be sufficient expertise in areas such as legal, accounting and underwriting matters.

The FSA requires accountability of senior management who are to be held responsible for the running of the business. The FSA requires firms to maintain a clear and appropriate apportionment of significant responsibilities amongst directors and senior management in such a way that it is clear who is responsible for what, and so that the business and affairs of the firm can be adequately monitored and controlled.[7]

Additionally, the *takaful* operator's systems and controls are very important. These are in place in order to ensure that risk is managed properly. Critical to this will be efficient and reliable information technology systems to process applications, handle claims and generally deal with administration. Any outsourcing arrangements will be examined for their robustness.

Determining *Shari'a* compliance is the responsibility of the *Shari'a* board, made up of Islamic scholars. The *Shari'a* board will examine the insurance products and the other aspects of the *takaful* operation and express an opinion on their acceptability under *Shari'a* law. While it is not for a secular regulator, such as the FSA, to certify *Shari'a* compliance, the FSA is likely to require a *takaful* operator to demonstrate that its systems and controls are adequate to ensure that *Shari'a* compliance is achieved. Appropriate questions for the FSA to consider might include the basis for appointing members of the *Shari'a* board, the quality of information and advice available to the *Shari'a* board, and the controls over product development and over investment policy and practices. While there can be no hard and fast rules, as scholars can disagree over such matters, the FSA is likely to focus upon, and require, proper governance for the nomination, appointment and operation of *Shari'a* board members. Internal systems and controls for providing information to the *Shari'a* board and giving effect to its rulings need to be robust.

Disclosure

It is critical for the FSA to have a clear picture of the nature of the operation in question and to understand in particular what are the risks, and how these are to be managed. To assist with this, the applicant will be required to submit a business or strategy plan to the FSA. Following authorisation, the applicant will be required to submit a number of reports to the FSA on a regular basis, including a financial report.[8] The applicant will also need to be co-operative and open in its dealings with the FSA both at the time of submission of its application and following authorisation.[9]

Should the *takaful* operator approach the issue of capital adequacy, as discussed above, by the dependence on the shareholders' paid-up capital or other funds due to the shareholders (for instance, inclusion in the Memorandum and Articles of Association of the *takaful* operator

that distributable funds may be retained to provide capital adequacy to policyholders) the FSA may require the *takaful* operator to provide express written notice of these circumstances to potential shareholders to aid transparency in their investments.

Any wakala fee that is due to the *takaful* operator and any profit-sharing that may occur, should a mudaraba model be used, will need to be disclosed to the participants under the principles of English common law as well as due to regulatory concerns.

Passporting

An insurer is able, pursuant to the European third Non-Life Directive[10] and Consolidated Life Directives,[11] to set up a branch in another European Economic Area (EEA) state or to do business there on a cross-border basis subject to satisfying the conditions of the insurance directives. These are commonly referred to as 'passporting' rights and they can be exercised after notification to the local insurance regulator.

A *takaful* operator that wishes to be authorised will need to give careful consideration to which EU regulator is to be the preferred 'home regulator'. A number of factors will need to be taken into account including:

- the regulatory hurdles to be overcome;
- the administrative burden in seeking authorisation;
- the capital requirements (including in respect of solvency margins). For example, the characterisation of the *Shari'a* compliant investment funds which a *takaful* operator might propose to invest in will require some analysis to establish whether these meet any diversification requirements;
- reserving requirements;
- attitudes to reinsurance, such as whether there is a concentrated risk exposure and what is the quality and creditworthiness of the reinsurance in place;
- the ongoing management supervision obligations;
- the costs involved on submission of an application for authorisation and ongoing periodic costs;
- the knowledge and attitude of the home regulator to *takaful*; and
- the willingness of the home regulator to accommodate any particular changes that are needed to the regulatory system to reflect *takaful* principles.

Bahrain

Takaful and re-*takaful* fall within the regulatory parameter of the Central Bank of Bahrain (CBB) (formerly the Bahrain Monetary Agency). The CBB has publicly proclaimed that its regulation of this market sector is intended to follow the guidelines laid down by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). The Insurance Rulebook (which comprises Volume 3 of the CBB Rulebook) constitutes the CBB's regulatory regime in this area and is designed not to favour one form of insurance over another – allowing both conventional insurance and *takaful* to operate in a competitive environment.

As briefly noted in the introduction, two models of *takaful* are usually adopted by commercial *takaful* operators; the *wakala* and mudaraba models. However, *takaful* operators which operate in the market in the Middle East have begun widely to adopt a model which mixes both the *wakala* and mudaraba models. In this mixed model, the *takaful* operator has two funds – one for the shareholders of the *takaful* operator and the other for the participants (the policyholders). The *al wakala* contract is used for underwriting activities while the *al mudaraba* contract is adopted for investment activities

The CBB has prescribed, in Module TA (*takaful* / re-*takaful*), the adoption of the mixed model pursuant to which the *wakala* model is adopted for underwriting activities and the mudaraba model for the investment activities of the *takaful* fund (TA – 3.1.10). By prescribing the use of the mixed model, the CBB is seeking to ensure that a common understanding of *takaful* is developed in the market and in the minds of consumers.

Consistent with the approach taken by the FSA, the CBB will refrain from taking a view as to whether the activities carried out by the *takaful* operator comply with the principles of the *Shari'a*. Instead, each licensed *takaful* firm is required to have a *Shari'a* supervisory board, to which that task is devolved. The CBB is, however, responsible for ensuring that consumers of *takaful* products are afforded the same level of protection as that afforded to the purchasers of conventional insurance products. The CBB also has an obligation to ensure that the operations of *takaful* firms do not represent a threat to the stability of Bahrain's financial services industry or wider economy.

It is also important to note that the CBB requires insurance firms to operate either on a conventional basis or on *takaful* principles – they cannot combine features of both.

Conduct of business

The CBB has adopted international standards of regulation and its Principles of Business, which apply to all applicants for authorisation (including *takaful* and re-*takaful* firms), are very similar to those set out above for the UK. *Takaful* firms must provide participants and shareholders with clear information about the performance of their business. This information is required, as a minimum, to comply with relevant AAOIFI standards.[12]

Capital adequacy

The capital framework laid out by the CBB for *takaful* operators maintains that all *takaful* funds are subject to available capital and solvency requirements, which are equivalent to their conventional counterparts. Each *takaful* fund must maintain and calculate its solvency requirements as if each *takaful* fund were a separate licensed insurance firm.

Module CA (capital adequacy) sets out in detail the minimum financial resources requirements for firms. The base requirement is for firms to maintain at all times capital available in excess of the higher of its required solvency margin and minimum fund. The minimum fund that must be maintained by each *takaful* fund is:

- Category 1 firm: BD 300,000
- Category 2 firm: BD 500,000

- Category 3 firm: BD 400,000; and
- Category 4 firm: The relevant minimum fund for Category 1 or 2 (depending upon the type of general business underwritten) plus the Category 3 minimum.

For each *takaful* fund, the required solvency margin is calculated on the basis of premiums written and claims incurred by the fund. A risk factor is applied to reflect the differing risk profiles of the different classes of insurance.[13] Assets of an insurance firm may only be given a value for regulatory purposes in accordance with the Valuation of Assets Regulations.[14] Assets which are considered inadmissible include intangible assets (such as brand value), and those that exceed permitted categories and counterparty limits.

Liabilities must be valued in accordance with International Accounting Standards (to the extent available) or until such standards come into operation, the Valuation of Liabilities Regulations.[15]

Takaful firms must maintain separate books of account in respect of each type of business and for each fund. The *wakala* fee charged for a *takaful* contract must be directly proportional to the costs associated with establishing and maintaining that contract. *Takaful* firms must establish a policy for the distribution of surplus but may only distribute a surplus if the firm meets its required solvency margin requirements both prior to and after the distribution. All Bahraini insurance licensees require CBB pre-approval for the distribution of dividends to shareholders.

In instances where the *takaful* fund's available capital fails to meet the required solvency requirements, the shareholder fund must provide a loan to the *takaful* fund in order for the deficient fund to meet its solvency requirements. Such a loan from the shareholder fund to the *takaful* fund must be pre-approved by the CBB as well as ensuring that the loan represents capital meeting the permanency and quality requirements outlined in the capital adequacy rules of the CBB.

Any loan from the shareholder fund will present an additional risk to the shareholders of the *takaful* operator. Due to this additional risk, the *takaful* operator must, as a minimum, include a specific note in its financial arrangements explaining the arrangements and their implications to shareholders.

Management, systems and controls

Similar to the requirements imposed by the FSA, the CBB requires adequate human resources and provides that those persons who occupy 'controlled functions' must be 'honest and straightforward in their dealings with customers'. Such controlled persons must act with due skill, care and diligence. Interestingly, whilst the CBB refrains from commenting upon whether any insurance product complies with the principles of *Shari'a* (similar to the approach taken by the FSA), the CBB has provided that membership of a *takaful* operator's *Shari'a* supervisory board is a controlled function (TA –2.1.3). As a 'controlled function' the CBB must approve the members of the *Shari'a* supervisory board. However, such approval is made on factors that do not relate to criteria based on the *Shari'a* but rather client-focused objective criteria, such as the observation of confidentiality in respect of client information.

The CBB also requires the *takaful* operator to take reasonable care to ensure its affairs are managed effectively and responsibly, with appropriate management and systems and controls. The CBB expects, with respect to Bahraini insurance licensees, for Bahrain to be the principal place of business and for Bahrain to be the centre of its governance and management. This means that the majority of board meetings must take place in Bahrain, the chief executive officer or general manager must be locally resident, and the premises and records for the firm must be located in Bahrain. The board must also assess, document and provide a written certification to the CBB annually detailing whether the internal corporate governance procedure that it has implemented has successfully achieved its objectives and whether the board has fulfilled its responsibilities for directing and monitoring the overall conduct of the firm's affairs.

Disclosure

As noted in the paragraph concerning loans from shareholder funds, above, the *takaful* operator must disclose to the shareholders the occurrence of a loan from the shareholder fund to the *takaful* fund due to the inevitable increased risk which the shareholders will bear.

In addition, disclosure requirements are also imposed so that the participants (the policyholders) are fully aware of the *wakala* fee and mudaraba profit-share rate that are to be paid out of the *takaful* fund and the shareholder fund.

Takaful firms are also obliged to file annual, quarterly and group insurance returns to the CBB providing details of the financial condition of the firm and the business undertaken.[16]

Malaysia

Malaysia introduced the legal basis for the establishment of *takaful* operators under the auspices of the Takaful Act 1984. The Act, together with the rules, regulations, guidelines and circulars issued thereunder, governs *takaful* business in Malaysia. *Takaful* operations are regulated and supervised by Bank Negara Malaysia (BNM), the central bank of Malaysia.

Unlike the approach taken by the CBB, the BNM does not prescribe any particular model to be used in the operation of a *takaful* provider. However, most *takaful* operators in Malaysia operate on the basis of the mudaraba model.

The Act divides *takaful* business into two classes:

- family solidarity business; and
- general *takaful* business.

Applicants may apply for a licence to carry on either businesses or both.

An applicant must satisfy the following requirements:

- it must either be a company (private or public) incorporated under the Malaysian Companies Act or be a society registered under the Malaysian Cooperatives Societies Act;
- it must have a minimum paid-up capital (which cannot be funded by borrowings) of MYR 100m. This is irrespective of whether the applicant is locally owned or has foreign shareholders;

- it must be a financially sound institution (preferably with experience in Islamic banking or conventional insurance/*takaful*); and
- it must demonstrate to the BNM (through its business plans) that it can contribute effectively to the development of the *takaful* industry in Malaysia.

The applicant must include the proposed ownership structure of the proposed *takaful* operator, including its direct and indirect control and major shareholders, their financial strengths, a review of past banking and insurance business ventures as well as the source of initial capital to be invested.

Foreigners are restricted from owning in aggregate more than 49 per cent of equity in a *takaful* operator. The BNM will look at the effective equity interest of foreign ownership of the *takaful* applicant. In other words, it will look up the chain of ownership to determine the extent of the foreign interest. The guidelines published by the Foreign Investment Committee of the Government of Malaysia on calculating effective equity interests of companies will serve as a guide for the BNM.

The Director-General of *Takaful* (who is also the BNM Governor) is responsible for the regulation of *takaful* operators. He must be satisfied that the *takaful* operator is fully *Shari'a* compliant and the Articles of Association of the *takaful* operator must provide for the establishment of a *Shari'a* advisory body (section 8). If he is so satisfied, the Director-General will refer the application to the Minister and the Accountant General who needs to certify to the Director-General that the applicant has made the necessary deposits under the Act.

Registration of a *takaful* operator can be cancelled in a number of circumstances, including where the *takaful* operator:

- pursues aims which are not *Shari'a* compliant;
- fails to maintain a surplus of assets over liabilities;
- carries on business in a manner likely to be detrimental to the interests of its participants;
- fails to effect satisfactory re-*takaful* arrangements;
- conceals material facts in its application for registration; or
- contravenes provisions of the Act.

The Act requires the *takaful* operator to establish its own *Shari'a* supervisory board to advise the *takaful* operator on the operations of its *takaful* business as part of internal governance to insure compliance with the *Shari'a*. This is similar, to what in practice will be employed in Bahrain and the UK. Malaysia, however, unlike Bahrain and the UK, also has a National *Shari'a* Advisory Counsel (NSAC) which operates under the authority of the BNM. The NSAC was established to streamline and harmonise the *Shari'a* interpretations amongst banks and *takaful* operators and acts as the sole authority advising the BNM on all *Shari'a* matters pertaining to Islamic banking and finance, including the evaluation of the *Shari'a* aspects of new products submitted to the BNM for authorisation.

In addition, in 2005, the BNM organised an annual *Shari'a* scholars' dialogue that brings together renowned scholars from around the world to discuss and learn from each other's experiences. The BNM has also established an endowment fund amounting to MYR200m to facilitate the activities of *Shari'a* scholars. The fund promotes research, provides scholarships

and is intended to facilitate and enhance discussion between *Shari'a* scholars and industry practitioners.

Capital adequacy

As well as ongoing capital adequacy requirements, the Act requires *takaful* operators in Malaysia to provide a deposit (either in cash, securities or with bank covenants in lieu of deposits) upon their incorporation (sections 13 and 14).

Every *takaful* operator is required to establish and maintain a *takaful* fund for each of the classes of business carried on by the operator. All receipts of the operator properly attributable to the business must be paid into the *takaful* fund. The fund's assets are only to be used to meet the operator's liabilities and expenses properly attributable to the underlying business to which the fund relates (section 16).

The assets of any *takaful* fund must be kept separate from the other assets of the operator (section 17). The Act also imposes restrictions regarding the ability of the *takaful* operator to distribute payments to shareholders until all their capitalised expenditure is written off (section 18).

Additionally, the Act provides for a *takaful* guarantee scheme pursuant to which the Director-General has the authority to utilise its fund to meet the administrative, legal and other costs of maintaining and administering *takaful* funds and the liabilities of any insolvent *takaful* operator. In order to maintain the *takaful* guarantee scheme funds, a levy is imposed upon all *takaful* operators (section 21).

Disclosure

Directors are required to disclose to the *takaful* operator any interests in proposed financial arrangements involving the operator. The *takaful* operator is, within seven days of receipt of such a declaration, obliged to provide copies of such disclosures to the Director-General, its auditor and all directors of the *takaful* operator (section 19).

A *takaful* operator is also obliged to give notice in writing to the Director-General of the fact that any person has become or ceased to be its managing director, director, chief executive or principal officer within fourteen days of the *takaful* operator becoming aware of that fact (section 32).

The Director-General has the power to inspect (under conditions of confidentiality) the *takaful* operator's books and records. The Director-General may also require any director or officer of the *takaful* operator to appear before him or furnish him with any additional information. A refusal to allow inspection or to appear before, or provide information to, the Director-General is an offence and carries with it a fine not exceeding MYR20,000 and a further daily fine of MYR5,000 for each day that the offence continues (section 33).

A similar power is given to the Director-General with respect to re-*takaful*. He may give a *takaful* operator notice in writing to produce for inspection treaties on re-*takaful* and any other re-*takaful* arrangements. If the *takaful* operator fails to produce the material required for inspection, he shall be guilty of an offence and be liable to a fine not exceeding MYR2,000 and a further daily fine of MYR100 for each day that the offence continues (section 23).

The Malaysian Financial Sector Master Plan

The Malaysian Financial Sector Master Plan, launched in 2001, is intended to be a blueprint for the development of the financial sector over a 10-year period. It stresses the development of *takaful* as an important component of the financial system. As part of the reforms introduced under the Malaysian Financial Sector Master Plan, investment restrictions for the *takaful* industry were liberalised to facilitate greater mobilisation of *takaful* funds into the Islamic capital market.[17] Efforts are being aimed at enhancing the efficiency of the system and building the internal resilience and competitive position of the *takaful* operators. As part of this process, *takaful* operators are being given guidance on improving their business strategies and a service quality index has been introduced to promote the development of world-class products and services. In tandem, an education programme has been instituted aimed at consumers to promote product understanding and transparency.

Dubai

Whilst the regulation of insurance in the United Arab Emirates comes under the purview of the Ministry of Economy,[18] financial services conducted in the Dubai International Financial Centre (DIFC) are regulated to international standards by the Dubai Financial Services Authority (DFSA). For the purposes of this chapter, we will be focusing on the regulatory structure as supervised by the DFSA.

Dubai's Prudential Insurance Business Module (PIN[19]) applies to every insurer. In other words, it applies to both conventional and *takaful* insurers (PIN 1.1.1). There is no prescribed model upon which *takaful* operations and investments should be based. The DIFC appears to have taken the view that, in circumstances where *takaful* is still an emerging product and no international consensus has been reached regarding the model to be adopted, it would not have been appropriate for the DIFC to impose a prescriptive regulatory regime.

To obtain a licence authorising it to conduct insurance business, an insurer must be a limited liability company incorporated under the Companies Law 2004, including a Protected Cell Company, or it must be a body corporate incorporated with limited liability under the laws of a jurisdiction other than the DIFC.

Management and control of risk

All authorised firms are subject to the systems and controls provisions of GEN 5 Management Systems and Controls.[20] The Prudential Insurance Business Module is intended to broaden the relevant requirements of the General Module to apply in an insurance context.

As a general proposition, an insurer's risk-management systems are required to be appropriate to the size, business mix and complexity of the insurer's operations and it must address all material risks to which the insurer is exposed whether these risks are financial or non-financial (PIN 2.2.1). An insurer must have a written risk management strategy which has been approved by senior management and which addresses all material risks which that insurer is likely to face. Risk management policies and procedures must be in place that are adequate to identify, assess, mitigate, control, monitor and report on material risks and there

must be clearly identified managerial responsibilities and controls which are designed to ensure adherence to the risk-management policies and procedures (PIN 2.2.2).

Particular risks are identified for which the risk-management system must be robust enough to identify and address. These include balance sheet and market risk, credit quality risk, reinsurance risk and operational risk. The latter includes (amongst others) technology risk, reputational risk, fraud risk, legal risk and business continuity risk (PIN 2.3.1 – PIN 2.3.4).

Record-keeping is also important. An insurer must maintain records which allow it to fulfil its obligations under contracts of insurance to which it is a party and which are capable of demonstrating that it complies with the rules in the Prudential Insurance Business Module.

Systems and controls

Takaful companies are also required to comply with the Islamic Finance Business Module (ISF)[21] which provides that compliance with the *Shari'a* ultimately rests with the senior management. A policy and procedures manual must be kept which demonstrates compliance with the *Shari'a*. The ISF also sets out requirements for the appointment and operation of a *Shari'a* supervisory board and the periodic undertaking of *Shari'a* reviews.

Capital adequacy

PIN 4 establishes the minimum required levels of capital resources applicable to insurers of different types. We have only focused in this section on the basic requirement that is applicable to all insurers. PIN 4 should be referred to for all other requirements. The basic requirement is that an insurer must have capital resources which are, in the opinion of its directors, formed on reasonable assumptions that are adequate for the conduct of its business, taking into consideration the insurer's size and the mix and complexity of its business (PIN 4.2.2). Systems and controls must be put in place which are capable of analysing realistic scenarios relevant to the insurer concerned and which can analyse the effects that those scenarios would have on the insurer's capital requirements and capital resources were they to happen (PIN 4.2.3). The guidance notes make it clear that an insurer is not required to measure the exact amount of its capital resources and its capital requirements on a daily basis but it should be in a position to demonstrate its capital adequacy at any time if asked to do so by the DFSA.

An insurer incorporated outside the DIFC needs to be aware of the requirement that it must have assets of a minimum quality available to meet its gross insurance liabilities arising from its DIFC insurance business plus a margin. Although an insurer must be able to cover its insurance liabilities gross of reinsurance, the insurer still has the benefit of its reinsurance protections, because assets may include amounts receivable from reinsurers in respect of gross insurance liabilities so long as the reinsurer concerned is rated BBB and above. The more detailed rules are contained in PIN 4.7.

If an insurer becomes aware that it does not comply with the requirements of PIN 4, it must take the following actions:

- notify the DFSA in writing immediately;
- stop writing any contracts of insurance (either, if it is an insurer incorporated outside the DIFC, through an establishment in the DIFC, or if it is an insurer established in the

DIFC, directly) until the DFSA has given it written permission to re-commence business; and
- must not make any profit or surplus distribution or return on capital without the DFSA's written permission (PIN 4.8.1).

In such circumstances, the DFSA's primary concern will be the interests of policyholders. The DFSA's usual approach is to work constructively and cooperatively with the insurer concerned to deal with problems of non-compliance or potential non-compliance. However, it reserves the right to take firm action to avoid exposing further policyholders to the risk of insurance failure where appropriate.

Measurement of assets and liabilities

PIN 5 sets out a number of principles for the consistent measurement of the assets and liabilities of insurers for the purposes of compliance with PIN 4 and reporting pursuant to PIN 6. It is not intended to impose a rigid basis of accounting for general purpose financial statements of insurers. Insurers are not prevented from adopting a system of measurement that is more prudent. The key, however, is that an insurer must not mislead the DFSA about its financial performance or its financial position.

The basis of accounting which must be adopted by a *takaful* insurer is the standards of the AAOIFI (PIN 5.3.2).

It should be noted that in calculating the base capital, *takaful* insurers may not include:

- the *takaful* operator's equity which does not participate in the surpluses or losses of the *takaful* business;
- amounts which are to be distributed to participants; and
- amounts to be distributed to a charity fund.

The *takaful* operator may, however, include amounts provided from the *takaful* operator's fund to the participants' fund which have not been repaid (PIN A3.4.3 and PIN A3.3.1).

Financial and other reporting by insurers

PIN 6 contains financial and other reporting requirements by insurers to the DFSA including requirements for the audit of the Annual Regulatory Return. Insurers must also prepare a Quarterly Regulatory Return but this is not subject to audit. The Annual Regulatory Return (accompanied by the auditor's report and any actuarial report) must be filed with the DFSA within four months of the insurer's reporting date (PIN 6.5.1). The Quarterly Regulatory Return must be filed within two months of the end of each period in respect of which the insurer is required to prepare a Quarterly Regulatory Return (PIN 6.5.4). The DFSA may, within 24 months of the filing date of the Annual Regulatory Return or Quarterly Regulatory Return, notify the insurer concerned that the document appears inaccurate or incomplete. In these circumstances, the insurer must within one month of notification from the DFSA correct any inaccuracies and make good any omissions and re-file the relevant parts of the documents (PIN 6.5.6).

Consolidated supervision

PIN 8 requires that an insurer provides the DFSA, periodically, with information regarding the structure and financial position of any group of which it is a member, to assess significant related party transactions and to notify certain transactions. A *takaful* insurer must report to the DFSA all distributions of profit or surplus to policyholders within 15 business days of the date of declaration of the distribution (PIN 8.4.3).

Run-off

PIN 9 deals with insurers in run-off and sets out requirements in relation to run-off plans, collateral for insurers in run-off, contracts for run-off and limitations on distributions by DIFC- incorporated insurers in run-off.

International Financial Services Board

The International Financial Services Board (IFSB) was established in November 2002, with the support of the Islamic Development Bank, the International Monetary Fund, and the AAOIFI. The IFSB serves as an international standard-setting body of regulatory and supervisory agencies for the Islamic financial services industry. To this end the work of the IFSB complements the International Association of Insurance Supervisors.

In the area of *takaful* regulation and standards, the IFSB has recently been working in cooperation with the International Association of Insurance Supervisors (IAIS) in the formulation of international standards for *takaful*. In this regard, a joint working group comprising representatives from the IAIS and the IFSB has been formed to assess the applicability of the IAIS insurance core principles for *takaful* and has produced an issue paper on *Issues in Regulation and Supervision of* Takaful. The issue paper has identified four major areas that require immediate attention. These are corporate governance, financial and prudential regulation, transparency, reporting and market conduct, as well as supervisory process, which may lead to the issuance of a specific guidance paper or standard that corresponds with the IAIS insurance core principles.

International Takaful Association

The International Takaful Association (ITA) is a *takaful* trade body to be based in Bahrain. Its purpose is to foster the growth and development of the global *takaful* industry and its establishment is being spearheaded by the CBB. In particular, it is aiming to:

- develop professionals working in the *takaful* industry;
- promote the establishment of strong legislative and regulatory processes governing *takaful*;
- foster sound and equitable principles in the ethical conduct of *takaful* business;
- build consensus on issues of importance in the *takaful* industry;
- encourage the development of appropriate *takaful* and re-*takaful* products; and
- promote the establishment of a re-*takaful* industry.

Its members currently include Islamic banks and *takaful* companies from Bahrain, Saudi Arabia, Kuwait, the United Arab Emirates, Jordan and Sri Lanka.

Conclusion

In considering the approaches to *takaful* in the UK, Bahrain, Malaysia and the DIFC, it is evident that its regulation is at different stages of development in each of the different jurisdictions. Both Malaysia and Bahrain are in the advanced stages of development, whilst Dubai is closely following with the DFSA making regulation a strong priority. This means that in practice there is no measure of international uniformity in the conduct of *takaful* business and its regulation.

The development of such international uniformity is key to facilitating the growth and global marketing of *takaful*. In jurisdictions where, historically, there has been low penetration of insurance products, this will assist in changing attitudes towards risk and will aid a growing awareness of the need for life and non-life cover. Initiatives such as the ITA will assist in promoting *takaful* globally and in developing standardisation in products and processes.

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1 Articles 3 and 75 FSMA (Regulated Activities) Order 2001.
2 *Carter v Boehm* (1766).
3 *Joel v Law Union and Crown Insurance* (1908) 2 KB 863.
4 Pursuant to the Interim Prudential Sourcebook: Insurers.
5 Integrated Prudential Sourcebook – PRU 2 Annex 1 Admissible Assets in Insurance.
6 Statement of Principle and Code of Practice for Approved Persons – APER 2.1.
7 Senior Management Arrangements, Systems and Controls – SYSC 2.1.
8 Supervision – SUP 16.3 and SUP 16.7.
9 Principles – PRIN 2.1 (Principle 11) and Supervision – SUP 16.3.
10 92/49/EEC.
11 2002/83/EC.
12 In particular, Standard 13 (Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies) and Standard 12 (General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies).
13 CA-2 contains detailed rules governing the calculation of the Required Solvency Margin.
14 The Valuation of Assets Regulations are contained in CA-4.
15 The Valuation of Liabilities Regulations is contained in CA-5.
16 Details of the content of the Insurance Firm Return can be found in BR-1.1.
17 Takaful Regulations 2003.
18 Federal Law No: (9) of 1984 on Insurance Companies and Agents.
19 Prudential – Insurance Business Module (PIN) [VER 3/08-06].
20 General Module (GEN) 5 [VER 11/08-06].
21 ISF [VER 1/09-04].

Chapter 17

The regulation of *takaful* in the Dubai International Financial Centre

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Introduction

The Dubai International Financial Centre (DIFC) is a financial free zone in the Emirate of Dubai, one of the seven Emirates that together make up the United Arab Emirates (UAE). It covers an area of 110 acres, and benefits from various privileges, including full foreign ownership, repatriation of profits, and a zero tax rate guaranteed for 50 years. The working language of the Centre and its institutions is English.

Most importantly, under the UAE federal law on financial free zones, although Emirates criminal law applies in the DIFC, Emirates civil and commercial law does not. This means that it has been possible to create a new system of law, based on international models and covering the law of contract, companies law, employment law, and so on. These laws are applied by a DIFC Court, operating on common law principles. At the time of writing, the Chief Justice is a British judge, Sir Anthony Evans.

The main institutions of the DIFC are the Court, the DIFC Authority (DIFCA) and the Dubai Financial Services Authority (DFSA). These three institutions are independent of each other, and their independence is guaranteed under Dubai law. The DIFCA is responsible for the site and its infrastructure, for laws not relating specifically to financial services, for business development, and for services to businesses established in the DIFC, for example obtaining residence visas for their employees.

The DFSA is an integrated financial services regulator like, for example, the UK Financial Services Authority (FSA) or the Monetary Authority of Singapore. It aims to operate to similarly high standards and benchmarks itself against the standards of the main international standard-setting bodies especially, in the context of *takaful*, the core principles of the International Association of Insurance Supervisors. The DFSA has power to recommend to the Ruler of Dubai laws relating to financial services and their regulation, to make rules and to publish guidance. Most of the detail of financial services regulation is at the level of rules, and experience has shown that, both in recommending laws and in making rules, the DFSA has remarkable speed and flexibility in responding to industry developments. It also has power to waive or modify rules in specific cases, and this allows it great scope to adapt to the circumstances of individual firms, where this is justified.

The DIFC has been conceived as a wholesale centre. There are certain limitations imposed on it by federal law and on others which implement this wholesale strategy. The effect of

these is that insurers cannot do business with individuals from the Centre, and the Centre is therefore focused on commercial lines and reinsurance.

The DFSA regime for insurance

The DFSA Rulebook is divided into modules. Since the DFSA is an integrated regulator, many of these apply to all firms. Some of these generally applicable modules are concerned with processes broadly speaking, how firms deal with the DFSA. Others are more substantive, for example the anti money laundering (AML) rules in the AML Module or the high-level systems and controls requirements in the General Module. This Rulebook structure, which is broadly similar to that of the FSA, means that there is not an 'insurance law' as such; rather, the regulatory regime for insurance involves a number of components from different modules of the Rulebook. This chapter is concerned mainly with the specifics of the regulation of *takaful*, it does not outline the whole of the regime, for example the provisions on claims handling contained in the Conduct of Business Module. However, it should be read bearing in mind that this supporting framework of insurance provisions is in place, and is more comprehensive than in many countries of the region.

One specific feature of the DFSA regime should also be borne in mind. Like European regulators, the DFSA does not attempt to regulate prices or contract terms for insurance – what American regulators would call 'rate and form'. Even if there were ever a justification for doing this – and it is specifically forbidden by European law – it would be extremely hard to argue that it applied to a commercial and reinsurance jurisdiction like the DIFC. In this area, a competitive international market is assumed.

The DFSA's capital regime for insurance is a risk-based regime, broadly akin to those in Australia and Canada. An insurer is expected to hold capital resources, of certain defined kinds, which exceed its capital requirement. The capital requirement is the sum of a series of risk components relating to individual risks, both on the asset and the liability sides of the balance sheet. For example, there is an investment volatility risk component which addresses the risk that investments such as equities will decline in value, and which is calculated by applying weightings to the insurer's holdings of the instruments to which market risks of this kind may apply. Similarly there is a reserving risk component which addresses the risk that the claims on past business will exceed the reserves held against them, and which is calculated by applying weightings to the amounts held for claims of different classes. These are only two of the 10 risk components that make up the capital requirement, although they are two of the more important ones.

Capital resources are defined in a way that, for conventional insurers, broadly equates to shareholders' equity, with certain adjustments. These adjustments are intended to restrict the eligible capital resources to those that are available to pay policyholders' claims, and that have reasonable long-term stability.

A firm which passes the DFSA's capital adequacy test is likely to have capital resources that would equate to an investment grade rating from one of the major rating agencies.

The capital regime is supported by rules on the valuation of assets and liabilities, through a requirement for an annual actuarial report, and through quarterly reporting to the DFSA.

There are also comprehensive rules and guidance on risk management, which are applicable to both conventional and *takaful* insurers.

The DFSA regime for Islamic financial services

Before discussing the application of the DFSA regime to *takaful*, it is necessary to discuss aspects of the DFSA regime that apply to all firms conducting Islamic financial services.

Under the Law Regulating Islamic Financial Business, and its supporting Rules (the Islamic Financial Business Module of the Rulebook), any firm which holds itself out as conducting Islamic financial business must have a specific endorsement on its licence entitling it to do so. (A firm holds itself out in this way if it represents that all or part of its operations are conducted in accordance with *Shari'a*.) It must appoint a *Shari'a* supervisory board (SSB) comprising at least three competent members, and there are provisions about conflicts of interest and the appointment and dismissal of SSB members. There are requirements for *Shari'a* reviews in accordance with the standards of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). If it is a fully Islamic firm (rather than an Islamic window), its constitution must provide that its business operations will be conducted in accordance with *Shari'a*.

The firm must establish an Islamic financial business policies and procedures manual. Among other things, this must set out how the SSB will carry out its role, how its fatwas, rulings and guidelines will be implemented, and how the internal *Shari'a* review will be undertaken. The firm must disclose to each customer the names of its SSB and, if the customer so requests, how its *Shari'a* reviews are conducted. Before distributing any marketing material, it must ensure that the SSB has reviewed the products or services to which the material relates.

It will be seen that the DFSA has defined its role as that of a *Shari'a* systems regulator. It requires Islamic firms, including *takaful* firms, to comply with *Shari'a*, and to have rigorous systems in place to ensure that they do, but does not itself attempt to interpret *Shari'a*.

In this, it differs from some other regulators. Although the DFSA sees the harmonisation of *Shari'a* interpretation as highly important for the future of Islamic financial services, it does not believe that in this respect it can succeed where others, so far, have not. It sees no point in adding one more set of local interpretations to those already existing in different jurisdictions. This would be especially inappropriate to an international centre, in perhaps the most international city of the Muslim world.

In its prudential conduct of business rules, the DFSA adopts a very balanced approach, integrating Islamic finance into mainstream wherever appropriate yet applying differential treatment when required. This is consistent with the approach taken by key Islamic industry standard-setting agencies, which are stressing the importance of closer integration between Islamic and conventional finance in order to make Islamic finance a sustainable part of the global financial system. This approach flows naturally from the fact that the DFSA is a risk-based regulator. At all points its concern is to identify the actual risks which Islamic firms pose, and where appropriate to mitigate them through the use of regulatory tools. Where the risks are similar to those posed by conventional firms, in general they will be mitigated in a similar way.

The DFSA regime for *takaful*

A *takaful* insurer must thus follow a strict set of *Shari'a* systems requirements, and a set of requirements common to other financial services firms, or specific to insurance. These include, for example, requirements for proper risk management systems or for communicating clearly and fairly with customers.

The capital regime for insurers outlined above is clearly applicable in its principles to a *takaful* insurer. The risk components respond to risks which exist for all insurers, whatever their form. It has therefore been possible to integrate requirements for *takaful* insurers within the regime.

For example, it has already been noted that capital resources are defined in a way that in a conventional insurer broadly equates to shareholders' equity, with adjustments. In the case of a *takaful* firm, when considering the *takaful* fund, the rules provide that amounts provided by loan from the owners' equity must be included. The amount of any *zakat*, or charity fund, must be excluded, because it is not available to pay any claims from contributors. The rules also define the treatment of owners' equity that has not been loaned to the *takaful* fund. If the terms of the firm's constitution, or its contracts, confine participation in surpluses or losses to the *takaful* policyholders, then owners' equity is to be treated in the same way as hybrid capital.

The application of the rules to calculate the capital requirement are in some ways even more straightforward. Much of the business undertaken by a *takaful* insurer is subject to the same risks affecting a conventional insurer, and risk components are applicable in the same way. It is, of course, necessary to specify the treatment applicable to certain Islamic contracts, in which a *takaful* insurer is more likely to invest than a conventional one, but this is not exceptionally difficult, and has been done in the DFSA's rules. The risk-based approach means that the rules respond naturally to some of the specific features and risks of *takaful*. For example, there are concentration factors that respond naturally to concentrations of counterparty risk, whether this stems from using a limited number of reinsurers or from a limited choice of investments. Such risks can occur in either conventional or *takaful* insurance, and the capital regime will respond in the same way in either case.

There are, however, two important points to be addressed. The first is the *takaful* model, in the sense of the contractual relationship between policyholders and the *takaful* operator. The DFSA has chosen not to mandate a particular model, at a time when there is no universally accepted model for the *takaful* industry. The DFSA is, however, concerned that, in addition to being acceptable to the firm's SSB, the model chosen should not provide perverse incentives. For example, it should not encourage the operator to write for volume, regardless of price. Nor should it encourage the operator to buy more reinsurance than is needed, to benefit from reinsurance commissions. So far, the DFSA has found acceptable a model using *al wakala* for underwriting activities and *al mudaraba* for investment activities. The *al wakala* contract contains a performance-related element related to the underwriting surplus generated in the *takaful* fund.

Although it is never possible fully to align the interests of shareholders and policyholders, even in a conventional insurance company, the areas where these interests conflict are well known and the mechanisms for managing them are established. In the much younger *takaful*

sector, the potential issues are much less explored, and regulators need to pay close attention to them in each case.

In this context, it should be noted that, although Islamic windows exist in some sectors, it is difficult to see how they could be used in *takaful*. To do so would create a further set of potential conflicts, between the interests of conventional and *takaful* policyholders. There would also be issues relating to the ring-fencing of investments. This does not, of course, preclude a conventional insurance company setting up a *takaful* subsidiary, as several have done around the world.

The second point is the formal structure of the *takaful* operation. There are broadly three models which have been explored. One is a fully mutual operation in which there are no other parties who expect to earn a return. This is broadly the model used in the Sudan. The second model is that of a mutual entity with an external commercial *takaful* operator, which manages the entity under contract. The third is of one or more mutual *takaful* funds embedded within an entity owned by, and operated on behalf of, shareholders. This seems to be emerging as the dominant model in Asia and much of the Middle East.

Accommodating the DFSA regime to all these models, and to the variants within them, can readily be achieved using the waiver and modification powers at the DFSA's disposal. For example, a *takaful* reinsurer within the Centre has a substantial modification to specify rules and appropriate capital treatment for one or more general *takaful* funds within the envelope of a shareholder company. This modification is based on an existing set of rules governing life funds, and of course on the basic capital framework. Like other DFSA waivers and modifications, it is a matter of public record.

Supervision of *takaful* firms

The paragraphs above have described the DFSA's approach to the regulation of *takaful*, with an emphasis on the regime as expressed in laws and rules. However, this is only one element of regulation. It is common currency among advanced regulators that the legal regime needs to be supported by active supervision, and by market infrastructure and discipline. As regards market infrastructure, both the DFSA and other agencies within the DIFC are trying to develop a more solid infrastructure for Islamic finance generally. This includes initiatives for the training of *Shari'a* scholars with a solid grounding in financial services, and also initiatives to develop Islamic capital markets, with a particular eye to developing bridges between the capital markets of the Middle East and those of Asia.

As regards supervision, the DFSA expects to have a continuous relationship with all firms providing financial services in the Centre. One element of this is regular risk assessments, the first of which normally takes place around six months after the firm begins operations. It examines a wide range of risk elements, from the external business environment to the quality of systems and controls in specific areas. In the case of any insurer, whether conventional or Islamic, these would include such things as controls over underwriting and the claims process, and the quality of the reinsurance programme. In the case of an Islamic firm, they would also include the *Shari'a* systems and controls, with a particular emphasis on whether the controls specified at the time of authorisation are actually working in practice.

From this risk assessment, a risk mitigation programme is developed to address those areas where risks can and should be mitigated. The single word 'should' embraces considerations of proportionality and cost benefit; insurance is inherently a risk business, and the carrying of economic risk is an inherent part of Islamic finance. In addition to risk mitigation, the risk assessment also determines the intensity of the DFSA's relationship with the firm, including specifically the time before the next full risk assessment. However, either of these can be modified by developments, whether in markets or in the structure and practice of the firm.

Future developments in the DFSA regime

Although the DFSA regime, being risk-based, is easier to apply to *takaful* than many others, and although the DFSA has remarkable flexibility to adapt its regime to the circumstances of individual firms, it remains true that the variety of *takaful* operating models is in itself a problem for regulators. Even within a single, basic model, there may be variations in fundamental matters, such as the strength of the obligation on an operator to fund by loan any deficit in the *takaful* fund. There may also be variations in the incentives on an operator, and in the conflicts of interest that may arise, for example when making investment decisions. *Takaful* is still a very young industry, and is still exploring fundamental questions, while the corresponding questions for the conventional industry were resolved many years ago.

In areas like this, a regulator may choose to pre-empt this exploration, by constraining the models that can be used, or, like the DFSA, maintaining a system that can be adapted to any model which is acceptable to the *Shari'a*. Neither approach is ideal, although the DFSA believes that its own approach has clear advantages for an international centre. The future clearly lies in harmonisation, whether this is achieved by regulators or by the industry focusing on a subset of the permissible models. In this respect the DFSA supports the work of the Islamic Financial Services Board on corporate governance in *takaful*, and looks forward to being able to implement its recommendations.

Chapter 18

Takaful: a regulatory perspective

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Introduction

Takaful is an Arabic word meaning 'guaranteeing each other' and is essentially insurance that is practised in accordance with *Shari'a* principles. The *tabarru'* (donation or gift) system is the main core of the *takaful* system, making it free from the concepts of uncertainty and gambling which are prohibited under the *Shari'a*.

An Islamic insurance company transacts business on a cooperative basis, in accordance with and subject to the principles of the *Shari'a*. All the functions of conventional insurance companies, such as underwriting, claims management, reinsurance, marketing, investment management and corporate governance, must be undertaken by a *takaful* provider in conformity with the principles of the *Shari'a*. *Takaful* is similar to cooperative insurance, where members contribute a certain sum of money to a common pool, which is then used to meet the claims made by members. The purpose of this system is not to make a profit from underwriting, which is prohibited under *Shari'a* law, but to share the risks. However, any surplus will be shared by both the insurer and the policyholders.

Whilst the operational framework of conventional insurance may be contrary to the tenets of the *Shari'a*, the basic concept of insurance is not. The *takaful* framework is based on solidarity, responsibility and mutual cooperation among members who agree to share the defined losses to be paid out. The operational framework of *takaful* avoids elements of *riba* (interest) and *gharar* (uncertainty), which are the basic reasons why *Shari'a* scholars consider conventional insurance as not conforming with the principles of the *Shari'a*.

Some notable differences between an Islamic insurance and conventional insurance are as follows:

- an Islamic contract of insurance should not involve any payment of interest as part of its investment activities;
- in the case of an Islamic life insurance policy, the nominee of the policy is not the beneficiary of the policy, but merely a trustee, on behalf of the legal 'heirs' of the policyholder;
- an Islamic insurance contract is only enforceable if it does not contravene the principles of *Shari'a*; and
- if the policyholder is unable to continue making contributions towards the insurance policy, then the policy may be terminated. However, any paid contributions must be returned to the policyholder, along with his share of the profits made over such paid contributions after deduction of any operational charges.

The core principles of *takaful* are that:

- policyholders cooperate among themselves for their common good;
- every policyholder pays subscriptions to help those that need assistance;
- losses and liabilities are divided among the community by a pooling system;
- no advantage is derived at the cost of others;
- funds are invested in *Shari'a* compliant instruments; and
- uncertainty is eliminated in respect of subscription and compensation.

The *takaful* industry has shown remarkable growth in recent years. This is evidenced by the increasing number of *takaful* companies worldwide, and the ability of these companies to provide a comprehensive range of products and services, matching those offered by their conventional counterparts. Despite such an influx of *takaful* companies, it is fair to say that the *takaful* industry is still in its infancy, especially when compared to its more mature Islamic banking counterpart. *Takaful* continues to enjoy significant growth as an Islamic alternative to conventional insurance, and has grown from being a regional to a global platform.

At the World *Takaful* Conference, held in Dubai in April 2006, industry leaders acknowledged that the following key areas need to be addressed by the *takaful* industry as a matter of priority:

- governance;
- the role of the regulator;
- prudential standards; and
- consumer protection and disclosure.

The challenge for regulators

Regulators must acknowledge the formative state of the *takaful* industry and that there continue to be a number of issues that need to be resolved. It is therefore paramount that the regulators encourage an open and dynamic market that allows for innovation, competition and transparency, so as to enable the *takaful* industry to develop and compete with the more established conventional insurance market, while at the same time ensuring that the relevant standards are implemented and observed. A majority of the regulators around the world are moving towards a risk-based approach to regulation. Whilst a risk-based approach to regulation may bring about some common standards, the following key issues remain in relation to the *takaful* industry:

- a lack of common interpretation of what constitutes a *takaful* contract;
- different accounting standards from region to region; and
- difficulty in asset classifications (acceptability of assets) / limited investment market (for *Shari'a* products).

Whether certain *takaful* arrangements are entirely *Shari'a* compliant is not itself free from doubt.

Takaful models

One model of *takaful* is based on the principle of *al wadiah* (deposit), whereby parties engage themselves in an agreement in which one deposits money with the other as an *ammanah*

(trust) for the purpose of safe-keeping. Some scholars consider this to be similar to an insurance contract.

A second school of thought is that the general practice of insurance is acceptable, except for life insurance. The argument is that having a life insurance policy involves elements of gambling and uncertainty and therefore is contradictory to the principles of the *Shari'a*.

A third school of thought is that insurance involves interest and uncertainty and is therefore not acceptable at all under *Shari'a*. The idea of buying protection against an unexpected loss could be contradictory to some *Shari'a* principles.

In practice, there are essentially two fundamental *takaful* models, which are widely accepted and practised.

- *The* wakala *(agency) model*: Under this model, a person or a group of people will delegate their rights or business to an operator, which will act as their agent and representative. In this model, the *takaful* operator is the provider of the business capital and takes on the business risk in developing and operating the *takaful* business on behalf of the participants. The *wakala* operator makes his income from the fees in relation to the contributions, risk premiums, investment returns and any surplus generated.
- *The* mudaraba *(cooperative) model*: A mudaraba contract is essentially a profit-sharing contract, where generally 100 per cent of any surplus is returned to the participants. There are variances between the different mudaraba models, wherein some operators share in the surplus and others do not. Similarly, some operators will charge the participants for expenses incurred when others do not.

Whilst the fundamental principles under both models are similar, in that they both operate on the principles of compensation and shared responsibilities where the resources are pooled to help others, there is divergence in views in terms of what constitutes insurance as well as the issues relating to the practice of *takaful* in general (see above).

From a regulatory perspective, the adoption of different *takaful* models should not be at issue. Most regulators work on the presumption that it is the board of the *takaful* entity that must ultimately be satisfied that the model chosen is appropriate for the business strategy being adopted and is *Shari'a* compliant. By prescribing the relevant model, the regulator may be unnecessarily restricting the industry. Instead, the regulator should focus on ensuring that the *takaful* operator has the relevant systems and controls in place to ensure *Shari'a* compliance.

Key regulatory issues to consider

On the regulatory front, Islamic finance in general continues to pose challenges to regulators in their quest to match the requirements of a conventional regulatory framework, while at the same time upholding the concept of *Shari'a*. Some key concepts that are of importance to regulators are the development of capital adequacy and solvency, risk assessment and corporate governance. Another challenge is to develop internationally acceptable standards for the regulation of the *takaful* industry, particularly in relation to the different *Shari'a* interpretations.

Many of the issues that have faced the *Shari'a* scholars over the years are being resolved with the inclusion of life *takaful*. However, some of the other issues, such as a common

practice between operators and the issue of sharing the surplus in a mudaraba contract remain to be resolved.

Transparency

Transparency is a key component that needs to be addressed within the *takaful* industry. The transfer of risk between the policyholder and the insurer in a *takaful* contract must be clear. It is only natural that both the insurer and the policyholder are interested in a rate of return that is fair and adequate for the risk being assumed. Unlike a conventional insurance contract, where the insurance company underwrites for a profit, the rate charged under a *takaful* contract cannot be excessive.

Size

The limited size of the Islamic investment market may be a constraint on the potential growth of the *takaful* industry. From a regulatory perspective, the *takaful* entity must be able to meet the appropriate solvency thresholds and the small size of the investment market could limit the extent to which the *takaful* entities can diversify their investments. Similarly, restrictions on investment strategy for a *takaful* entity may limit the potential for investment returns, which could in turn lead to a higher pricing of the risk and thereby put the *takaful* entity at a disadvantage to its conventional counterparts.

Asset-management capabilities

The success of the *takaful* industry is linked in many ways to the asset-management capabilities of the Islamic finance industry. The funds from the shareholders as well as the policyholders must be invested in a *Shari'a* compliant manner. A strong asset manager will provide the best possible investment returns for the *takaful* entity, thereby enhancing the returns for the shareholder and the policyholder. The investment industry is seeing some interesting initiatives within the private equity, structured alternative investments and *sukuk* sectors. The introduction of *sukuk*, in particular, as an asset class, has allowed the *takaful* industry to create new long-term insurance products. A *takaful* entity can essentially mobilise long-term premiums and invest them in the available Islamic investment avenues. As custodians of policyholder monies, *takaful* entities must not only ensure that the funds are *Shari'a* compliant, but are soundly managed to instill confidence amongst the increasingly sophisticated public, particularly in terms of delivering returns.

Capital requirements

Issues remain from the viewpoint of what constitutes acceptable assets for calculation of capital requirements. A number of models that are used by regulators for calculating capital requirements rely on the use of rating criteria for asset classification as well as for investment volatility purposes. As many Islamic investments are not rated, a number of Islamic investments (other than *sukuk*) do not get due recognition and therefore may be categorised inappropriately.

Financial strength is a key factor when considering the risk posed by an insurance company to the policyholder and a regulator is therefore keen to ensure that a company has adequate

financial resources, particularly when assessing the company's susceptibility to large losses. As the *takaful* industry expands, the risks increase and as a result put a strain on the capital supporting the *takaful* entity. Of particular significance is the ability of the *takaful* entity to raise capital to counter any capital erosion in times of strain. A conventional insurance company generally retains a significant proportion of its profits and can also raise any additional capital from external sources. A *takaful* entity has access to similar capital-raising solutions; however the effectiveness of some of the capital supporting the venture needs to be verified for its robustness, such as the commitment of the capital for the longer term and also the ability of the capital providers to respond to large loss scenarios.

Contract certainty

Contract certainty is another buzzword in the conventional insurance industry. The *takaful* industry should work towards developing standard clauses of contract that define the relationship of the parties to the contract, especially addressing the issue of contributions in relation to different *takaful* models and distribution of the surplus. It is widely acknowledged that there is a need to standardise the terminology and the definitions for use in contract documents.

Re-*takaful*

The absence of a robust re-*takaful* industry is proving to be another constraint on the growth of *takaful*. *Takaful* entities are continuing to rely on the conventional reinsurance markets in order to mitigate risk. Building a robust re-*takaful* industry would not only serve to strengthen and enhance the financial capacity of the *takaful* industry, but would ultimately contribute towards the overall robustness of the Islamic financial system.

There is an enormous scope for the expansion of *takaful* not just within the Muslim community, but also with non-Muslims. A number of non-Muslims may find *takaful* to be an attractive proposition, due to its ethical investment policies. The Islamic financial industry is gaining wider acceptance and recognition and has expanded well beyond the traditional borders of the Muslim-based economies and into the major industrial economies, thereby becoming an integral component of the global financial system.

Regulatory institutions

There are several international institutions that are working towards international *Shari'a* compliant standards, including the Islamic Financial Services Board (IFSB), International Association of Insurance Supervisors (IAIS) and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI). This is a positive step, as the insurance industry in general, both *takaful* and conventional, is operating in the same environment. The role of the regulator should be directed towards developing a common and consistent regulatory framework that would allow development of the *takaful* industry and create new *takaful* products. As we are aware, the insurance culture in the Islamic world is at a relatively early stage of development. There is an enormous need to educate people about the benefits of *takaful*. The *takaful* industry can play a significant role in educating the Islamic world on the benefits of *takaful* and insurance in general. Regulators must again work along with the industry on this issue as it will help contribute towards the development of the market generally.

Regulation of *takaful* in the QFCRA

The Qatar Financial Centre Regulatory Authority takes a somewhat less interventionist approach to *takaful* insurance than some of its regional counterparts. The provisions of its rulebooks relating to *takaful* are to be found in the *Islamic Finance Rulebook* and the *Prudential Insurance Rulebook*, which contains a chapter entitled 'Additional Requirements for *Takaful* Entities'.

In order to carry on *takaful* insurance in the QFC, a QFCRA authorised insurer must first apply to the QFCRA for an 'endorsement' to its authorization permitting it to conduct 'Islamic Finance Business' (that is, the business of carrying on one or more regulated activities in accordance with Shari'a') either as an Islamic finance institution ('an authorised firm whose entire business operations are conducted in accordance with Shari'a') or by operating an 'Islamic Window' (whereby a firm 'conducts Islamic financial business as a part of its business operations').

Operating as an Islamic financial institution entails certain additional requirements designed to ensure *Shari'a* compliance. These include establishing a 'policies and procedures manual' designed to address *Shari'a* compliance issues, the appointment of a Shari'a Supervisory Board. Membership of such a board is not, however, a controlled function and is thus not subject to the approval of the QFCRA. The board is required to prepare an annual report (in accordance with AAOIFI standards on governance) on the firm's compliance with the *Shari'a* and must submit that report to the QFCRA. An Islamic financial institution is required to disclose to clients the membership of its Shari'a Supervisory Board along with the manner and frequency of it *Shari'a* reviews.

Beyond these relatively high-level requirements which essentially provide that Islamic financial institutions must police themselves, the QFCRA does not choose to intervene on matters of *Shari'a* compliance. In particular the QFCRA does not require a *takaful* insurer to organise its business according to any particular models. The only structural requirement is that the insurer maintains segregated *takaful* funds and identifies the assets and liabilities attributable to each. The QFCRA applies its risk-based capital adequacy model to the firm as a whole rather (referred to as the '*takaful* entity') than to individual *takaful* funds. This avoids the possibility of a *takaful* fund requiring a free loan from shareholder funds.

As for distributions of surplus, a firm is required to maintain a written policy for determining the surplus or deficit arising from each category of its *takaful* business, the basis of distributing that surplus or deficit between the participants and the shareholders, and the method of transferring any surplus or deficit to the participants. Such policies must comply with AAOIFI standards including Financial Accounting Standard No. 13. A *takaful* entity may not make any distribution from a particular takaful fund if the entity does not meet its minimum capital requirement, or would not do so if the distribution was made. Again, the possibility of policyholders actually having to pay an additional contribution to make up a deficit on a *takaful* fund is offset by the option (in accordance with AAOIFI FAS 13) of borrowing the shortfall from the shareholder funds.

The only other QFCRA provisions relating to *takaful* insurance prohibit an insurer from making a loan from a *takaful* fund. They require the firm to make certain disclosures in its financial statements including its approach to allocating the surplus or deficit on the *takaful* fund.

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1 Please note that the views and comments expressed within this chapter are the individual views of the author and do not represent the views of any organisation or person with which the author may be associated.

Chapter 19

The legal and regulatory framework of the Malaysian *takaful* industry

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Introduction

This chapter analyses the general approaches taken by the regulator of the *takaful* industry in Malaysia towards developing a comprehensive legal and regulatory framework governing the *takaful* industry. The chapter also discusses the main building blocks of the *takaful* regulatory framework in Malaysia as well as highlighting some key strategic initiatives that serve as the foundation for ensuring the orderly growth and sustained development of the *takaful* industry in Malaysia.

Takaful regulation: general approaches

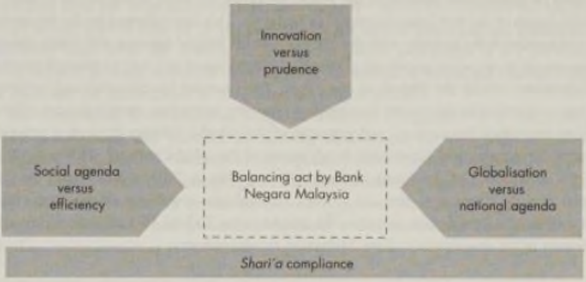
As one of the pioneers in the establishment of the new-emerging *takaful* industry, designing an appropriate regulatory framework for the *takaful* industry in Malaysia poses a unique challenge for the regulator. A number of conflicting objectives and targets have to be analysed and put into a proper perspective or order. A structured strategy that is a combination of some key approaches seems to form the main thrust of the overall design of the *takaful* regulatory framework in Malaysia as follows.

First, at the upper strategic level, a clear target has been set so as to ensure that equilibrium is achieved to balance the conflicting objectives among the regulator, operators, consumers as well as other domestic and international stakeholders (see Exhibit 19.1). In balancing these conflicting objectives, the main thrust for the *takaful* regulation has always been directed towards facilitating the development of a dynamic, competitive and efficient *takaful* industry and safeguarding the interest of the participants (policyholders) while ensuring that the operations of *takaful* business conform to the principles of the *Shari'a*.

Secondly, in designing and implementing a regulatory framework for the *takaful* industry in a dual system where conventional insurers and *takaful* operators are operating side-by-side, a holistic approach has been adopted in formulating a framework that not only takes into account the unique characteristics peculiar to the *takaful* business, but that does not put *takaful* operators at a comparative disadvantage and affect their competitiveness and growth potential in the overall financial system. In this dual environment, it is vital to maintain

Exhibit 19.1

Considerations in formulating regulation



Source: Author's own

Exhibit 19.2

The approach in regulatory forumulation

Approach	Example
Adopt the common regulatory standards applicable to the conventional insurance sector	• Fit and proper criteria for directors and senior management
Adapt regulatory standards applicable to conventional insurance sector with modifications to suit the specificities of *takaful* operations and the *Shari'a* requirements	• Investment policy that needs to be tailored to ensure *Shari'a* compliance • Disclosure requirements that clearly set out the proper contractual relation, rights and obligations of the parties in the *takaful* contract
Formulate a separate regulatory standard to address the unique characteristics of *takaful*	• *Shari'a*-governance framework to ensure *Shari'a* compliance

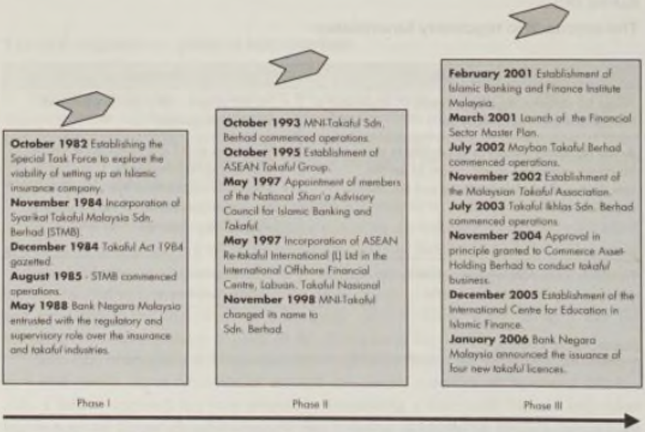
Source: Author's own

harmonisation within the regulatory infrastructure, whilst ensuring the specificities and unique features of *takaful* operation are safeguarded. The approach in regulatory formulation has therefore been three-fold, as Exhibit 19.2 illustrates.

Thirdly, acknowledging that the existence of infrastructure is key to the sustainability of this new industry, a cumulative and phased-in approach towards the institutional development based on need and readiness of the industry has been adopted. The initial phase of development focused on institutional building in the 1980s, providing the basic infrastructure to allow the establishment of the first *takaful* operator in Malaysia. This was followed by the introduction of competition to the industry with the entry of another *takaful* operator and enhancement of international cooperation among the regional *takaful* operators as a way to promote re-*takaful* arrangements among the players in the 1990s. The financial liberalisation and heightened global competition in the twenty-first century, however, necessitate more intensive efforts to further strengthen the capacity and potential of the *takaful* industry through a process of structural expansion and accelerated development of the *takaful* industry. This is reinforced by the introduction of the Financial Sector Master Plan in 2001, which charts the future direction of the financial system and outlines the strategies to achieve an effective, efficient and resilient financial system, including the *takaful* sector. Exhibit 19.3 provides a chronology of events in the development of the Malaysian *takaful* industry.

Exhibit 19.3

Chronology of events in the development of the Malaysian *takaful* industry



Source: Author's own

The building blocks of the *takaful* regulatory framework

Since its establishment more than 20 years ago, the *takaful* industry in Malaysia has consistently registered strong growth and has proven to be resilient in the face of intense competition from the more advanced insurance industry. The *takaful* industry has recorded average annual growth rates of 27 per cent and 19 per cent in assets and net contributions respectively since 2000. By 2005 it had reached a market penetration of 6.1 per cent, a manifestation of growing awareness of the public to the benefits of the *takaful* scheme. Exhibit 19.4 illustrates the performance of the Malaysian *takaful* industry.

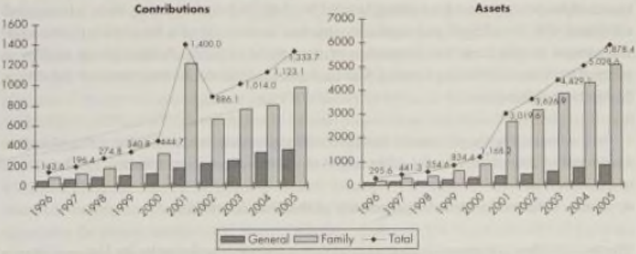
The encouraging development of *takaful* in Malaysia is supported by a strong *takaful* regulatory framework that provides an enabling environment for its orderly growth and development. In essence, the comprehensive regulatory infrastructure in Malaysia consists of the robust legal structure that underpins the establishment and operations of *takaful* operators, strong *Shari'a* governance to ensure the *Shari'a* compliant conduct and operations of the players, sound prudential and governance standards to address the risk management aspect as well as strong consumer protection and supervisory regimes.

Robust legal framework

Islamic finance is recognised in Malaysia as a complete system forming part of the mainstream financial system. This is evident from the enactment of a dedicated legislation governing the establishment, registration, conduct and operation of *takaful* operators in Malaysia. Enacted in 1984, the Takaful Act provides certain powers to the regulator to supervise the industry and requires the establishment of a *Shari'a* committee by the *takaful* operator which serves as a foundation for ensuring that the business operations of a *takaful* operator are in compliance

Exhibit 19.4

Performance of the *takaful* industry



Source: Author's own

with *Shari'a* principles at all times. A comprehensive review of the Takaful Act is being undertaken at time of writing (mid-2006) as part of the continuing efforts to enhance the effectiveness of the legislative framework governing the *takaful* industry and strengthening the consumer protection in line with the rapidly changing environment surrounding the industry.

In addition to the proposed review of the Takaful Act 1984 as the main legislation for the *takaful* industry, a structured mechanism in the form of the Law Review Committee has been set up to ensure that other relevant legislation would continue to facilitate further development of the industry and to ensure a conducive legal environment to cater for the unique nature of transactions in Islamic finance to continue to exist. Among others, the Law Review Committee is responsible for reviewing the existing laws, including tax and stamp duty laws, company laws, land laws and procedural laws, and making recommendations to the relevant authorities to enable the smooth execution of Islamic financial contracts. For instance, the tax neutrality policy for banking and finance in order to create equitable tax treatment of Islamic financial transactions vis-à-vis similar conventional transactions has been recommended to, and thereafter adopted by the government.

To enhance the dispute resolution mechanism for cases involving Islamic finance, a dedicated High Court has been established to adjudicate all *muamalat* cases (this refers to previous *Shari'a* rulings (fatwa) relating to particular cases involving commercial and financial disputes) in the Commercial Division of High Court Kuala Lumpur since 2003. The establishment of the dedicated High Court for Islamic finance is aimed at expediting the hearing of Islamic finance cases and further increasing public confidence in Islamic banking and finance.

To complement the court system, the Regional Centre for Arbitration Kuala Lumpur is well positioned to serve as an alternative dispute resolution mechanism for Islamic finance, especially for high-scale financing facilities. The Regional Centre for Arbitration Kuala Lumpur is readying itself to be the international arbitration centre for Islamic banking and finance business, in line with Malaysia's effort to be the regional centre for Islamic banking and finance.

Strong *Shari'a* framework

A comprehensive *Shari'a* framework to govern the operation of *takaful* business is recognised as one of the pre-requisites for a strong and stable *takaful* industry. A strong *Shari'a* framework combined with sound legal and regulatory structure is essential as a foundation to accelerate the pace of development and innovation of the *takaful* industry. A three-prong strategy is adopted towards establishing a strong *Shari'a* framework for the Islamic financial industry in Malaysia as follows:

- first, set out a *Shari'a* governance structure with appropriate organs to achieve this objective;
- secondly, strengthen *Shari'a* supervision to ensure *Shari'a* compliance by the *takaful* operators; and
- thirdly, enhance the level of competency of the *Shari'a* scholars.

The two-tier *Shari'a* framework adopted in Malaysia includes regulation by the National *Shari'a* Advisory Council in Bank Negara Malaysia and *Shari'a* committees established in each of the *takaful* operators.

The National *Shari'a* Advisory Council in Bank Negara Malaysia

The National *Shari'a* Advisory Council (now known as the *Shari'a* Advisory Council for Islamic Banking and *Takaful* (SAC)) was established in Bank Negara Malaysia in May 1997 with the objective of determining the *Shari'a* rulings on Islamic banking, finance and *takaful* transactions conducted by financial institutions under the purview of the Bank. It has the authority to harmonise any differences of *Shari'a* interpretation for matters within its jurisdiction. The Central Bank of Malaysia Act 1958 and the Takaful Act 1984 were amended in 2003 to reinforce the role of the SAC and provide legal recognition as the authoritative body on *Shari'a* matters relating to Islamic banking and finance. In addition, the status of the SAC has been elevated as the reference point for the court and arbitrator in any dispute that involves *Shari'a* issues on cases involving Islamic banking and finance.

Shari'a committees

A *takaful* operator is required by law to establish a *Shari'a* committee as part of its internal governance in order to ensure compliance with the *Shari'a*. Bank Negara Malaysia has issued the Guidelines on the Governance of *Shari'a* Committees for the Islamic Financial Institutions to further strengthen the *Shari'a* governance of Islamic financial institutions. The Guidelines were issued to enhance uniformity of *Shari'a* decisions by streamlining the functions and duties of *Shari'a* committees in the industry with that of the SAC. The Guidelines also set the competency level for each member of the *Shari'a* committees in an effort to enlarge the pool of *Shari'a* personnel competent in Islamic banking and *takaful*.

In terms of *Shari'a* supervision, Bank Negara Malaysia accords continuous focus to assess the compliance of *takaful* operators with the *Shari'a* principles and governance process. Bank Negara Malaysia also evaluates the effectiveness of *Shari'a* committees in providing proper advice and validating the *Shari'a* compatibility of the daily operational matters. Similarly, the internal auditors are also required to consciously play their role in ensuring that *takaful* operators comply with the *Shari'a* principles by formulating a comprehensive audit program for *Shari'a* compliance and equipping themselves with the required knowledge in performing their duty.

Bank Negara Malaysia also undertakes a number of significant initiatives to develop and promote *Shari'a* dynamism and convergence on the international front. It includes the organisation of *Shari'a* scholars' dialogues with the objective of promoting convergence and harmonisation of *Shari'a* interpretations and appreciation among the *Shari'a* scholars in the development of Islamic banking and finance at the global front. The dialogues which have been held, both at the international and regional levels, have provided a good networking platform to bridge the gap amongst *Shari'a* scholars in terms of fostering understanding and appreciation of *Shari'a* implementation in various jurisdictions and to facilitate the integration of the domestic Islamic financial system with the global Islamic financial system.

The other initiative undertaken by Bank Negara Malaysia is the establishment of the RM200m Fund for *Shari'a* Scholars in Islamic Finance. The *Shari'a* Fund will provide the resources to finance *Shari'a* research activities, scholarships for *Shari'a* studies as well as organising the annual international *Shari'a* scholars' dialogue. The *Shari'a* Fund will facilitate the creation and development of competent *Shari'a* scholars equipped with sound knowledge and expertise in both Islamic laws and *Fiqh Muamalat* to deal with the ever-changing dynamism of the Islamic financial industry.

Flexible operational framework

Takaful operators have the flexibility of operating their *takaful* business under different *takaful* operational models. There are two operational models adopted by the *takaful* operators.

Mudaraba (profit-sharing) model

Two Malaysian operators adopt the mudaraba (profit-sharing) model in their business operations, with several variations in terms of treatment of management expenses, product design and the distribution channels. Under the mudaraba contract, the *takaful* operator acts as a *mudarib* (entrepreneur) and the participants as *rabbul mal* (capital providers). The contract specifies how the surplus from the *takaful* operations is to be shared between the *takaful* operator and the participants. Under this type of contract, losses are borne by the participants as the capital provider. However, to protect the interest of the participants, the *takaful* operators are required to observe prudential rules including provision of interest-free loans by the operators to the *takaful* risk funds in the event that there is deficiency in the *takaful* risk funds.

Wakala (agency) model

The other operators in Malaysia apply the *wakala* model in their business operations. The *wakala* concept is essentially an agent-principal relationship, where the *takaful* operator acts as an agent on behalf of the participants and earns a fee for services rendered. The fee can be a fixed amount or based on an agreed ratio of investment profit or surplus of the *takaful* funds.

Prudential and governance framework

In the conduct of the *takaful* business under both operational models, *takaful* operators are required to comply with the *Shari'a* principles and prudential requirements. The overall guiding principles for the formulation of comprehensive and sound prudential and governance standards are illustrated in Exhibit 19.5.

Strong market conduct and consumer-protection framework

A strong consumer-protection framework is essential to maintain public confidence in the *takaful* industry and hence enable the *takaful* operators to effectively perform their role within the economy as a mobiliser of long-term savings. Promoting sound business practices and the fair treatment of consumers within such a framework is critical with mounting pressures on *takaful* operators to achieve business growth under increasingly more competitive conditions.

A multi-pronged approach has been adopted in developing a comprehensive market conduct and consumer-protection framework, encompassing initiatives to promote the visibility of *takaful* products and services, enhance the financial literacy and awareness among consumers as well as strengthen the regulatory framework governing market practices by introducing guidelines and circulars. Exhibit 19.7 summarises the initiatives that have been implemented in the area of strengthening market conduct within the *takaful* industry.

Exhibit 19.5

Guilding principles for prudential and governance standards

Principle 1	**Maintain and ensure fairness** in pricing, managements and terms of contracts to protect participants' interests.
Principle 2	**Achieve a balance between profit maximisation and prudent management of funds** to ensure that there is a sufficient level of reserves in the *takaful* funds while meeting the expectations of the shareholders.
Principle 3	**Disclosure and transparency** with the objective to enhance corporate governance and protect the interests of participants.
Principle 4	**Level playing field between *takaful* operators and insurers** by ensuring that convergence is achieved as far as possible between the frameworks applicable to *takaful* and insurance, so as to ensure that similar risks are dealt with in a consistent manner.

Source: Author's own

Effective supervisory framework

Whilst the appropriate regulations and standards are vital to ensure the orderly development of the *takaful* industry, of equal importance is the oversight and monitoring of the *takaful* operators through effective supervision by the regulatory authority to ensure that the players operate in a sound and safe manner, and the prudential requirements are observed. Lack of oversight, inadequate checks and balances, and over-exposure to risks are amongst the factors that may result in vulnerabilities not only to the *takaful* industry, but to the financial system as a whole. Since 2003, Bank Negara Malaysia has embarked on a strategic shift in its supervisory philosophy and approach, which has resulted in a transformation from a bottom-up, audit-based supervision approach to one that is more holistic and forward-looking. This is achieved via the implementation of the Risk-Based Supervisory Framework. The new supervisory process uses a structured approach to assess a *takaful* operator's risk profile, its financial condition, and the adequacy of its operational management and risk management systems, in order to form an overall assessment of the insurer's or *takaful* operator's health and the likelihood of key risks materialising in the future.

In line with the increasing focus on consumer protection, supervision of the conduct of *takaful* operators is also carried out to ensure that the rights of participants and the public are appropriately protected. Under the new framework, market conduct supervisions are dealt with separately using a separate supervisory framework. The results of both supervisory processes will be consolidated to reflect appropriately the *takaful* operator's overall position in terms of its financial condition and market conduct.

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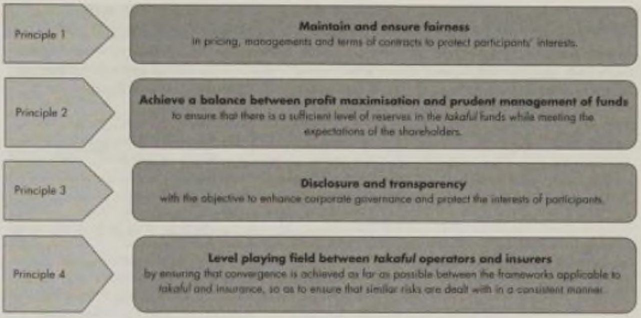

Source: Author's own

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Exhibit 19.6

Guidelines regulating *takaful* operators

Area	Guidelines
To ensure adequate protection of the *takaful* funds, guidelines and circulars have been issued to safeguard the *takaful* funds so as to ensure that the funds are not depleted through improper usage and unsound investments.	• Guidelines on operating costs of family *takaful* business impose limits to control acquisition costs, improve operational efficiency of *takaful* operators and provide better value for contribution to participants. • Guidelines on claims settlements practices specify the minimum standards for prompt and fair payment of claims as well as ensure that payment of claims is made on a timely manner. • Takaful (Prescribed Financial Institution, Loan and Investments) Regulations 2003 specify the investment avenues of the assets of *takaful* funds so as to ensure a balance between profit maximisation and prudent management of *takaful* funds.
Strengthen corporate governance and risk management practices	• To ensure the effectiveness of overall management, *takaful* operators are required to observe the Guidelines on Directorship for *Takaful* Operators, which govern the appointment of directors and chief executives and the setting up of board committees, including a risk management committee. • In addition, *takaful* operators are also required to observe prudential limits and conditions imposed on the outsourcing of the management of *takaful* funds so as to ensure that the funds are properly managed within the accepted risk management framework.

Source: Author's own

Focus has also been accorded to enhance the overall information system (IS) governance as well as to promote IS best practices in the *takaful* operator in response to the rapid development of technology. These include on-site examinations, off-site monitoring, issuance of guidelines on the management of the IS environment and improving the standards of IS supervision by benchmarking against other proven IS auditing standards. Effort is also being directed at developing a system to enhance the off-site monitoring function through a database of information on the development and usage of technology by the *takaful* operators. This would provide a mechanism for early warning on potential systemic risks and benchmarking of core processes across the *takaful* operators.

Key strategic initiatives

At the core of the regulatory building blocks of the *takaful* industry, there are several strategic initiatives undertaken to strengthen the regulatory and supervisory framework of the *takaful* industry. Some of the key strategic initiatives are explained below.

Exhibit 19.7

Initiatives to strengthen market conduct in the *takaful* industry

Approach	Detailed actions
Increase market visibility through vigorous consumer awareness campaign.	• Islamic Banking & *Takaful* Week and Islamic Banking & *Takaful* Expo. Nationwide campaigns to promote and increase the visibility of Islamic banking and *takaful* through publication of articles, media events, exclusive forums and exhibition booths. • Bank Negara Malaysia's 10-Year Consumer Education Programme, known as 'InsuranceInfo' includes the publication of a series of booklets on *takaful* which provide relevant information to consumers about *takaful* products, their costs and benefits, processes and documentation involved in the *takaful* cycle as well as the rights and responsibilities of the various parties to a *takaful* contract.
Issue guidelines/directives to enhance market conduct practices as well as to ensure proper disclosure and transparency.	• Guidelines on prohibition against unfair practices in *takaful* business. • Guidelines on proper advice practices for *takaful* operators and agents of family *takaful* business. • Minimum standard on product disclosure and transparency in marketing medical and health *takaful* plans. • Guidelines on claims settlements practices. • Guidelines on financial statement for *takaful* operators. • Implementation of *takaful* operators statistical system.

Establish structured dispute resolution framework.	• Operator's dedicated complaint unit for first-level complaint resolution.
	• Bank Negara Malaysia Laman Informasi Nasihat dan Khidmat (LINK) for second-level complaint resolution.
	• Financial Mediation Bureau to provide speedy and cost-effective mediation to address consumer complaints on claims up to:
	  • RM200,000 (motor and fire *takaful*);
	  • RM5,000 (third party property damage); and
	  • RM100,000 (others).
	• Dedicated division in the High Court to adjudicate all Islamic banking and finance matters.

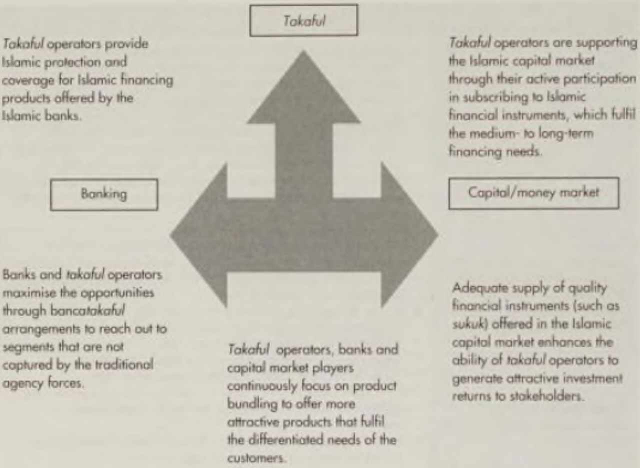
Source: Author's own

The development of a comprehensive Islamic financial system

In developing the *takaful* industry, a comprehensive approach is taken by placing equal emphasis on all core components of the overall Islamic financial system, namely the Islamic banking, the *takaful*, and the Islamic money and capital markets. Exhibit 19.8 illustrates how this is structured. The development of the core components in a structured manner creates synergy, thus providing a conducive environment for the Islamic financial system to be an efficient mobiliser of resources and provider of financing for productive economic activity. This enables the *takaful* operators to keep pace with their conventional counterparts in terms of providing

Exhibit 19.8

The interdependency of Islamic market players



Source: Author's own

competitive, *Shari'a*-approved products. The comprehensive structure also enhances the resilience and robustness of the Islamic financial system to withstand financial shocks and contributes to increase the overall stability of the Malaysian Islamic financial system.

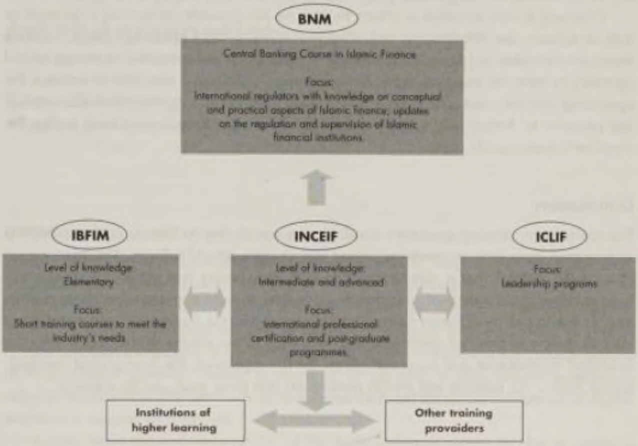
The development of human talent

To sustain and support the future growth of the *takaful* industry, an important prerequisite is the development of the talent and expertise that is needed to drive innovation and to raise the performance of the *takaful* industry to greater success. The key success factor lies in *takaful* operators having a high level of expertise in all relevant areas: the management of *takaful* business including technical, actuarial, distribution, underwriting, investment, and understanding of the *Shari'a*, as well as strong leadership at the helm.

To be able to assist in meeting this increasing demand for intellectual capital, several initiatives have been taken to develop human capital at all levels in Islamic finance, including the leaders, the technical personnel as well as the regulators. It includes the establishment of

Exhibit 19.9

Total human capital development solution for Islamic finance



Source: Author's own

dedicated training and educational centres such as the Islamic Banking and Finance Institute Malaysia (IBFIM), the International Centre of Education in Islamic Finance (INCEIF) and the International Centre for Leadership in Finance (ICLIF). There are also strong strategic alliances with foreign international players, whereby a number of *takaful* licences have been issued to highly-reputable international financial institutions with the objective, among others, to enhance the technical knowledge in the market.

The promotion of a dynamic, consumer-centric approach

In the rapidly changing and competitive financial landscape, a significant challenge for the *takaful* industry is to compete effectively and sharpen its competitive edge to respond proactively to the more sophisticated and differentiated demand of more discerning consumers. Indeed, more demanding customers with higher expectations will see greater consumer activism exerting its influence on the *takaful* industry.

Extensive efforts have therefore been undertaken by *takaful* operators to understand the needs of different customer segments, build better customer relationships and address the

preferences of specific customer segments. A wider range of products, such as annuities, investment-linked and medical and health products, are now available to meet the needs of the customers. These efforts are undertaken with the recognition that customer acceptance is key to the success of this industry.

Emphasis is also accorded to efforts to improve the consumer-protection framework as well as enhance the effectiveness and efficiency of the *takaful* operators. Focus has been directed to formulate and develop comprehensive policies and initiatives that encourage *takaful* operators to meet the expectations of the consumers. Continuous measures to enhance the operational efficiency and effectiveness of the *takaful* operators and improve the market conduct and practices to further safeguard the interest of consumers have always been among the regulator's main agenda items.

Conclusion

The challenge to develop regulatory standards that remain true to Islamic core principles is an important element in the development and growth of the *takaful* industry. The development of a *takaful* industry that is able to contribute towards stability and balanced growth needs to be achieved in the context of a rigorous and robust legal, regulatory and supervisory regime. This is reinforced by effective supervision, a strong *Shari'a* framework, and an efficient judicial system to promote confidence and soundness in the *takaful* industry. It is with the combined commitment and concerted efforts by the regulators, the international standard-setting bodies, the industry and market participants that these goals can be achieved.

Chapter 20

Moody's approach to analysing *takaful* companies

Timour Boudkeev
Moody's Investors Service

Introduction

Takaful has shown very impressive premium growth rates of about 20 per cent since 2000. Total *takaful* premiums exceeded US$2bn in 2005, and are expected to reach US$7.4bn by 2015. It is believed that one of the key reasons for the remarkable pace of growth relates to the difficulties that traditional insurers are facing in complying with the *Shari'a* as a result of their investment strategies. A typical conventional insurer will commit a substantial portion of its investment portfolio, usually in excess of 80 per cent, to fixed-income securities in order to reduce risk on the asset side of its balance sheet and maximise the amount of capital available to support its liabilities.

Indeed, asset risk can often be one of the more important factors driving an insurer's credit ratings. However, under the *Shari'a*, *riba* (interest) is forbidden, which disqualifies conventional bonds as an acceptable asset class. This restriction also imposes limitations on certain sources of funding for the insurer, such as senior or subordinated debt, or hybrid capital. In addition, as equity investments can only be made in *Shari'a* compliant companies, this rules out investments in businesses involved in alcohol, gambling, pork-related products and conventional financial services, to name just a few.

The development of *takaful* goes hand in hand with that of other types of innovative *Shari'a* compliant financial products, such as those in the areas of Islamic banking and Islamic capital markets. Indeed, access to Islamic financial products is very important for a *takaful* company as they offer the best way to build a non-*riba* asset base without exposing the company to excessive risk, as would be the case if *riba* was avoided by allocating a large portion of the portfolio to equities and/or real estate.

The main concept that differentiates *takaful* from conventional insurance is that of co-operation, or solidarity. A *takaful* company is similar to a conventional mutual insurer, in that its purpose is not to generate profits but to share risk between members, thus making it more manageable for each of them. Importantly, however, consideration for the insurance service is classified as a 'donation', not a 'premium', which may have implications for the structure of certain long-term life insurance products.

What benefits does a rating offer to a *takaful* company?

As is common for conventional insurers across the world, the financial strength of *takaful* operators will not be uniform. As such, and particularly bearing in mind the increasing competition, obtaining a financial strength rating from a recognised international rating agency may demonstrate to fund members that their company provides them with adequate financial security. In some countries, being rated can also have regulatory benefits, as regulators increasingly incorporate rating agency views into their frameworks. Going through the rating process also demonstrates to the outside world, including reinsurers, the adequacy of internal steering and risk management systems.

Many of the *takaful* companies are quite young and do not yet have an established track record. While this in itself is not an impediment to being rated, it is important to have appropriate risk management structures and practices in place to successfully complete the rating process. The pedigree and track record of senior management, as well as the breadth and depth of the management and actuarial teams, also tend to play a very important role.

Analysing the financial strength of a *takaful* company: Moody's approach

As noted, there are substantial similarities between most common types of *takaful* and mutual insurance. As a result, and given that the distinction between a 'premium' and a 'donation' is in most cases more cultural than economic, Moody's approach to analysing a *takaful* company is very similar to that of a conventional mutual insurance company. Below is a description of Moody's global methodology for rating insurance companies (the overall framework applies to both life companies and property and casualty companies, with some minor differences).

However, the credit strengths and weaknesses of a typical *takaful* company will be influenced by a number of considerations that do not apply to a Western mutual insurer. As a result, at the relevant point in the description of the methodology, we will discuss additional considerations relating to corporate governance, asset allocation, structural features, capitalisation strategies and the regulatory environment that need to be taken into account when rating a *takaful* company.

It should be noted that in general Moody's does not view mutual (cooperative) operating structures as better or worse than shareholder structures. Indeed, many mutual insurers in Western Europe are rated A3 or better for insurance financial strength, generally in line with publicly traded peers of a similar size and business profile.

Moody's methodological framework

Moody's insurance ratings reflect its opinion of a company's long-term relative risk and are, of necessity, forward-looking in nature because they apply to liabilities that may pay out over long periods of time. Historical experience has shown that looking only at the current financial condition of the company is not always an accurate predictor of the company's future financial performance and financial strength. Therefore Moody's analytical approach includes not only

quantitative analysis but also a significant degree of qualitative analysis incorporating the opinions and judgments of experienced analysts.

Moody's approach to rating the various obligations of insurance organisations is rooted in an assessment of the financial strength of the main operating units within those organisations. This assessment is represented by the insurance financial-strength ratings that it assigns to operating insurers. It first develops a financial-strength rating for a stand-alone entity before taking into consideration any parental support that may also be factored into the final rating. It frequently also assigns other ratings within the group (for example, on senior unsecured debt issued by the insurer or its parent company). Any such ratings are typically determined with reference to the insurance financial strength ratings of the group's main subsidiaries.

Below, the seven key factors underlying an insurer's business and financial profile are reviewed. This discussion illustrates how these factors are assessed in the rating process, and why each factor is important to the assignment of stand-alone ratings. We will then explain the other most common more qualitative considerations that Moody's takes into account, before moving on to a brief discussion of how the rating agency factor in parental support, which is the final stage in arriving at the assigned insurance financial-strength rating.

Note that what follows is a summary outline of the rating process involved. Moody's has recently published detailed reports explaining how its insurance analysts globally measure each rating factor, combine these measurements to arrive at the stand-alone rating, and then build in other considerations to arrive at the final rating.

Key rating factors: business profile

Factor I: Market position, brand and distribution

Market position and brand

A company's market position, brand and franchise strength represent its ability to develop and sustain competitive advantages in its chosen markets, which can have a direct bearing on its future profitability and ability to generate capital internally. In addition, an insurer with a strong market position, brand and competitive advantage should be well-positioned to withstand prolonged difficult market conditions, and be better able to capitalise on new, potentially profitable opportunities that may develop in the future. It is believed that such companies are more likely to meet their obligations through varied economic periods, thus suggesting higher ratings. Conversely, a weak business franchise can indicate financial stress for a company if it generates low or erratic core profitability, and may tempt management to enter unfamiliar businesses, take on new and unfamiliar risks, or leverage the company to a greater extent.

Distribution

The methods and mechanisms by which an insurance company delivers its products are another fundamental aspect of the company's business and credit profile. A company's access to distribution channels, its ability to control those channels and its relationship with its producers relate directly to its ability to grow revenues, retain business, align its distribution with specific product/customer segments and control its costs.

Factor 2: Product risk and diversification

A company's chosen lines of business affect its creditworthiness, as individual product segments and classes of business exhibit different volatility and competitive attributes. Product risk appears in many forms and can have significant adverse effects on earnings and capital adequacy. In addition, diversification in earnings, product and geography is a positive credit characteristic because it can reduce the volatility of a firm's earnings, capital and cash flow, promoting more efficient use of capital resources. However, if a company enters a business line without appropriate underwriting expertise, diversification can be a credit negative.

Key rating factors: financial profile

Factor 3: Asset risk

High-risk assets

Insurance companies' core assets are typically concentrated in high-quality, liquid assets in recognition of the uncertainty of their liability payout stream. However, companies will often allocate a portion of their investment portfolios to higher-risk assets. Such exposures must be monitored constantly, as changes in the market environment, especially during periods of stress, can depress asset values, earnings and, ultimately, the capital base.

Reinsurance recoverables

A significant asset of uncertain value on property and casualty insurers' balance sheets is recoverables/receivables from reinsurers. The analysis of the amount of a company's reinsurance recoverables, its concentrated reliance on a few reinsurers, and the credit quality of the individual reinsurers is important. This is because write-offs of the recoverables as uncollectible could impact the insurer's income and capital, and the loss of reinsurance capacity could require the insurer to modify its market/product focus.

Goodwill

Another potentially significant asset of uncertain value on insurers' balance sheets is the goodwill associated with acquisitions, whose economic value is often highly uncertain and not readily realisable.

Takaful consideration: strategic asset allocation policies

A *takaful* company's assets may differ from those of a typical Western insurer as regards their liquidity and volatility characteristics and risk/return profiles. For example, some *takaful* insurers may exhibit a propensity to overweight *Shari'a* compliant equities and real estate assets.

Shari'a compliant bonds may have concentration in certain geographical areas (for example, the Gulf states and Malaysia), which, in the absence of credit enhancement by an international institution, may increase the risk profile of the *takaful* fund. The effect of the alternative investment strategy on overall profitability will also need to be ascertained.

Factor 4: Capital adequacy

At the heart of Moody's assessment of an insurer's creditworthiness is an opinion about the company's economic capital and its capital adequacy (for example, solvency) or operational leverage. Capital adequacy is critical for an insurer because regulators require minimum capital levels or ratios for the company to continue to operate. Capital constraints can also restrict a company's ability to grow its business and impact its strategy.

Factor 5: Profitability

An insurer's earnings capacity – quality and sustainability – is a critical component of its creditworthiness because earnings are a primary determinant of its ability to meet its policy and financial obligations, the primary source of internal capital generation to assure capital adequacy, and a key determinant of access to the capital markets on favourable terms. Diversification across multiple product lines and markets can result in more stable levels of earnings, increasing the predictability of internal capital growth and strengthening claims/debt-paying ability.

Factor 6: Reserve adequacy / liquidity and asset/liability management

Reserve adequacy (Property and Casualty)
Inadequate loss reserves have been a key cause of most Property and Casualty insurance company failures over the past decade. Given the broad accounting latitude endemic to the insurance business, the importance of credible loss reserves cannot be over emphasised. The evaluation of redundancy or deficiency in an insurer's loss and loss-adjustment reserves has an impact on the analysis of its reported earnings as well as the assessment of capital adequacy. When Property and Casualty insurers' loss reserves develop unfavourably, the impact on the company's financial profile and flexibility can be material, as seen by the decrease in capital, the increased operating and financial leverage ratios, and a reduced dividend-paying capacity to the holding company.

Liquidity and asset/liability management (Life)
Life insurance liabilities are highly confidence-sensitive in nature. Lack of liquidity can quickly result in a company's inability to meet the demands on its liabilities. As a result, financial problems, real or perceived, can lead policyholders to surrender their policies, and in doing so create a 'run-on-the-bank' scenario, and prompt regulatory intervention or a company's insolvency. Consequently, a Life insurer's ability to carefully manage its asset/liability risk and its associated liquidity is critical.

***Takaful* consideration: structural features of family products**
The profit-sharing mechanism of long-term *takaful* products may have certain distinctive features. For example, the determination, crediting and payment of profit participation on life policies, as well as the structure of any explicit or implicit guarantees, will need to be carefully examined when evaluating a *takaful* company's asset/liability management.

Factor 7: Financial flexibility

It is important that a company is able, not only to fund its business growth via internal capital generation, but also to demonstrate the ability to service its obligations without stress. Insurers benefit from being able to raise capital externally for additional growth or acquisitions, and to meet unexpected financial demands. Financial flexibility – as dictated by financial leverage/double leverage, earnings coverage, dividend coverage, and access to capital markets – is a key determinant of the insurer's credit profile.

> ***Takaful* consideration: long-term capitalisation strategy and regulatory environment**
> While the capital structure of a *takaful* company is not in itself conducive to large distributions (the fund is in many cases *de facto* not distributable), ongoing profit-sharing may be subject to competitive pressures and, as such, vary in time and by market. The position of the supervisory authority with regard to capitalisation, and its ability and willingness to enforce the regulation in place, will also tend to influence the *takaful* company's financial strength.

Qualitative considerations

Management, governance and risk management

Management characteristics

The quality of management underpins corporate success or failure, and is a major factor in determining ratings. The rating company assesses the management's credibility, experience and reliability. Management's ability to develop a strategic vision and its ability to execute that vision are critical factors for a company's success in a competitive industry where the status quo is changing rapidly. A review of the insurer's strategy includes the firm's long-term vision, risk-return appetite, attitude towards financial and operating leverage, strategies for raising capital, and value creation. Growth strategies can also impact its risk profile.

The overall risk culture that management has built will strongly affect the company's appetite for, and management of, risk and leverage. As a result, management's strength, its discipline in financial planning and risk management, and its ability to execute are vital elements in their evaluation of credit risk.

Throughout the rating process, Moody's forms an opinion of a management team's likely response to challenges in the firm's economic, competitive and regulatory environment given their goals and motivations.

Corporate governance

Corporate governance, as promoted by the board of directors, is equally responsible for the financial health and credit profile of the company. The rating agency evaluates the corporate board's independence, expertise and involvement, as well as its ability to align governance

practices with proper oversight of the management team and corporate strategy. Independent review of the key financial reporting and risk-management processes is important, as is oversight of compliance and regulatory issues.

Moody's also assesses how policyholders may behave with regard to their investment, in the normal course of events and times of stress. They believe there is a natural and effective alignment between the interests of managers and directors with policyholders and creditors at a mutual insurer. However, drawbacks associated with the mutual structure often include less management accountability and transparency – a concern that becomes significant when the mutual has adopted an aggressive strategy that is more characteristic of a stock company.

***Takaful* consideration: corporate governance**
Corporate governance of a *takaful* company has some distinct features. The founding members of the company appoint a *Shari'a* advisory board, which then opines on the compliance status of the company with Islamic law. Management is also appointed by (and accountable to) the founders, not by the *Shari'a* board. Therefore, while their management is under no formal obligation to follow guidance of the *Shari'a* board, in practice, instances of insubordination are rare as it is the prerogative of the board to declare non-compliance with *Shari'a* rules, which may prejudice the status of the company as a going concern.

The key performance indicators used by the *Shari'a* board to assess the management of the operating company may have a greater focus on compliance with Islamic law than technical issues, such as underwriting performance and risk management. The nomination process to the board, as well as the background of members appointed to it, will also be critical in ascertaining the quality of corporate governance and its ramifications on the financial strength of the *takaful* fund.

Risk management
Although taking risks, in underwriting, investments, acquisitions or other areas, is a necessary activity for an insurance company, it is vital that management (and the board of directors) understand and adequately manage the risks assumed in order for the company to maintain its financial performance and flexibility, reputation, market position and confidence in the capital markets.

Accounting policy and disclosure

Relevant and timely financial information is a critical part of any financial analysis. Although many insurers prepare information under generally accepted accounting principles, others may use a regulatory basis of accounting that may differ from such principles. The presence

of a strong government/independent body for financial standards is considered a positive factor when evaluating an accounting regime.

When evaluating accounting principles, the rating agency considers how well financial reporting mirrors economic reality. Where it believes the economics of a transaction are not consistent with financial reporting, its may adjust financial statements to facilitate its analysis.

Sovereign and regulatory environment

The local jurisdiction's economic and political stability and the degree of government support or interference can have a strong impact – either positive or negative – on an insurer's credit profile. A well-developed local capital market may aid a company's ability to raise sufficient capital efficiently to grow or cushion itself against adverse conditions. The credit profile is also influenced by local regulatory rules and practices, potential changes in regulations or product taxation, and failure-resolution mechanisms. In measuring a company's sovereign and regulatory environment, Moody's makes use of foreign currency and local currency country ceilings.

Evaluating support

While the above factors are critical in determining an insurer's stand-alone rating, analytical consideration of support – explicit or implicit – from a parent company or affiliate is required to arrive at the public rating, which is sometimes higher than the company's stand-alone rating.

Support from a parent company or affiliate

Any such support, once determined, is generally 'added' to the rating by narrowing the spread between the stand-alone credit rating of the entity/security and the rating of the entity providing the support.

Ultimately, the extent to which the affiliation benefits the rating is a matter of judgment, not convention, given the many variables that must be considered. The rating agency's assessment may vary depending on its view of how important that entity is to the overall enterprise business model, its integration with the rest of the organisation, and the company's ability and willingness to support it. Support is evaluated in terms of past actions of the supporter as well as current public statements of support, combined with its judgment of prospective economic motivations. Support may raise a company's rating, but not necessarily to the same level as that of the supporting entity.

Factoring in support from entities other than related ones

Moody's does not ascribe a meaningful level of implicit government support to insurance companies: history has shown that governments have allowed insurers – even large ones – to fail without intervention. However, if the insurer were directly government-owned, support would be considered under Moody's methodology for government-related issuers. If the insurer

is part of a bancassurance group, and there is clear evidence that failure of the insurer will affect the creditworthiness of banking operations, the likelihood of support by the government may increase in selected cases.

Conclusion

Takaful has many similarities with conventional mutal insurance, although there are several important differences. As in the case with other mutal (cooperative) structures, Moody's does not view *takaful* as better or worse than shareholder structures. Moody's approach to rating *takaful* companies is consistant with the rating methodologies applied to conventional insurers, and encompasses both qualitative (for example, market position, brand, distribution, product risk, diversification) and quantitative (for example, asset risk, capital adequancy, profitability, etc.) factors. In addition, an assessment of risk management and corporate governance, external support as well as the sovereign environment also plays a very important role.

Glossary

Takaful Keluarga: *Family takaful*

Akaun Peserta Akaun yang dikreditkan sebahagian caruman peserta bagi tujuan pelaburan/simpanan.
Participant's Account *An account where a portion of contributions from the participant is credited for the purpose of investment/savings.*

Akaun Khas Peserta Akaun yang dikreditkan sebahagian caruman peserta bagi tujuan tabarru'.
Participant's Special Account *An account where a portion of contributions from the participant is credited for the purpose of tabarru'.*

Anuiti Takaful Kontrak yang memperuntukkan pendapatan secara berkala selepas bersara bagi sesuatu tempoh yang bergantung kepada hayat seseorang.
Takaful Annuity *A contract that provides a stream of periodic income upon retirement for a term dependent upon human life.*

Banktakaful Promosi dan pemasaran produk takaful oleh institusi perbankan.
Bancatakaful *Promotion and marketing of takaful products by the banking institutions.*

Caruman Caruman wang yang dibayar sekali atau berkala oleh peserta kepada pengendali takaful bagi tujuan pelaburan dan tabarru'.
Contributions *Monetary contribution provided once or periodically by a participant to a takaful operator for the purpose of investment and tabarru'.*

Deposit Pengendali Takaful Semula Amaun yang didepositkan dengan atau disimpan oleh pengendali takaful sebagai jaminan pelaksanaan kontrak takaful semula oleh pengendali takaful semula.
Re-takaful Operator's Deposit *An amount deposited with or retained by a takaful operator by way of security for performance by the re-takaful operator of its re-takaful contracts.*

Dokumen Sijil Bukti kontrak antara peserta dengan pengendali takaful yang menetapkan terma dan syarat sijil berkenaan.
Certificate Document *An evidence of a contract between a participant and a takaful operator which sets out the terms and conditions of the particular certificate.*

Jadual Kemortalan Jadual perangkaan yang menunjukkan kadar kematian pada setiap peringkat umur, pada kebiasaannya dinyatakan sebagai bilangan kematian bagi setiap ribu.
Mortality Table *A statistical table showing the death rate at each age, usually expressed as the number of deaths per thousand.*

Kadar Perbelanjaan Nisbah jumlah perbelanjaan bagi sesuatu tahun (termasuk komisen, gaji dan lain-lain) kepada jumlah pendapatan caruman selain daripada caruman tunggal dan pembayaran untuk anuiti.
Expense Rate *The ratio of total expenses for the year (including commissions, salaries, etc) to the sum of total contribution income other than single contribution and consideration for annuities.*

Laporan Keadaan Kewangan Laporan daripada aktuari yang dilantik mengenai keadaan kewangan perniagaan takaful keluarga pada akhir tahun kewangan.
Financial Condition Report *A report by the appointed actuary on the condition of the family takaful business at the end of the financial year.*

Lebihan Aktuari Lebihan kumpulan wang takaful keluarga yang telah ditentukan melalui penilaian aktuari pada akhir tahun kewangan.
Actuarial Surplus *Surplus of the family takaful fund determined by actuarial valuation at the end of the financial year.*

Lebihan pada Tarikh Penilaian Lebihan daripada kumpulan wang takaful dihantar ke hadapan daripada liabiliti aktuari kumpulan wang perniagaan takaful keluarga.
Surplus at Valuation Date *Excess of the takaful fund carried forward over the actuarial liabilities of a takaful fund of family takaful business.*

Pendapatan Pelaburan Bersih Pulangan ke atas pelaburan tolak kadar nilai dan cukai.
Net Investment Income *Returns on investments less rates and taxes.*

Rider Lampiran kepada sijil yang mengubahsuai syarat-syarat untuk meluaskan faedah.
Rider *An attachment to a certificate that modifies its conditions by expanding benefits.*

Takaful Berkaitan Pelaburan Kontrak yang mempunyai nilai manfaat sijil pada satu-satu masa berubah-ubah berdasarkan nilai aset pada waktu berkenaan.
Investment-linked Takaful *A contract where the certificate benefits at any time vary according to the value of the underlying assets at the time.*

Takaful Keluarga Individu Manfaat takaful yang kena dibayar kepada individu apabila berlaku kematian kepada peserta atau memperuntukkan pendapatan secara berkala kepada peserta selepas bersara.
Individual Family Takaful *Takaful benefit payable to an individual on death of the participant or providing periodic income to the participant upon retirement.*

Takaful Keluarga Berkumpulan Takaful keluarga (pada kebiasaannya tanpa melalui pemeriksaan perubatan) yang dikeluarkan di bawah satu sijil induk bagi melindungi sekumpulan orang. Takaful keluarga pada kebiasaannya dikeluarkan kepada majikan untuk faedah para pekerjanya, atau kepada ahli sesebuah persatuan.
Group Family Takaful *Family takaful on a group of people under a master certificate. It is typically issued to an employer for the benefit of employees, or to members of an association.*

Takaful Perubatan dan Kesihatan Kontrak yang memperuntukkan pembayaran manfaat rawatan perubatan yang ditetapkan seperti kos kemasukan ke hospital, kos pembedahan dan fi perundingan doktor terhadap risiko seseorang yang didiagnosis menghidapi penyakit tertentu atau kecederaan akibat kemalangan.
Medical and Health Takaful *A contract that provides specified medical treatment benefits such as the cost of hospitalisation, surgical and physician consultation fees against risks of a person being diagnosed with certain illnesses or having injury arising from an accident.*

Tuntutan Pemberitahuan kepada pengendali takaful bahawa pembayaran sejumlah manfaat harus dibuat menurut terma sijil.
Claims *Notification to a takaful operator that payment of an amount is due under the terms of the certificate.*

Takaful Am: *General takaful*

Caruman Bersih Caruman kasar tolak semua caruman takaful semula yang kena dibayar.
Net Contributions *Gross contributions less all re-takaful contributions payable.*

Caruman Langsung Kasar Caruman berdasarkan kadar kasar asal yang dikenakan atas pelanggan bagi perniagaan takaful langsung tanpa sebarang potongan komisen atau brokeraj.
Gross Direct Contributions *Contributions on original gross rate charged to clients in respect of direct takaful business without any deduction for commission or brokerage.*

Fasal Purata Menetapkan bahawa kadar bahagian kerugian yang ditanggung oleh kumpulan wang takaful bergantung pada jumlah nilai dilindungi kepada jumlah nilai risiko.
Average Clause *Stipulates that a takaful fund is only liable for such proportion of the loss as the sum covered bears to total value at risk.*

Indemniti Pemulihan kerugian kepada pihak yang menuntut dengan cara bayaran, pembaikan atau penggantian.
Indemnity *Restoration to the claimant of a loss by payment, repair or replacement.*

Kerugian Menyeluruh Kerugian yang cukup besar sehingga boleh dianggap tidak bernilai lagi.
Total Loss *A loss of sufficient size so that it can be said there is nothing left of value.*

Kerugian Tertanggung Tetapi Tak Dilaporkan Kerugian yang telah berlaku sepanjang tempoh yang ditetapkan, kebiasaannya bagi satu tahun kewangan, tetapi masih belum dilaporkan kepada pengendali takaful semasa tarikh pertimbangan.
Incurred But Not Reported (IBNR) *Losses which have occurred during a stated period, usually a financial year, but have not yet been reported to the takaful operator as of the date under consideration.*

Keuntungan/Kerugian Pengunderaitan Pendapatan caruman terperoleh tolak tuntutan bersih kena dibayar, komisen dan perbelanjaan pengurusan.
Underwriting Profit/Loss *Earned contributions income less net claims incurred, commissions and management expenses.*

Nisbah Bendungan Nisbah caruman bersih kepada caruman langsung dan caruman takaful semula diterima kasar tolak takaful semula dalam Malaysia.
Retention Ratio *The ratio of net contributions to gross direct and re-takaful accepted contributions less re-takaful within Malaysia.*

Nisbah Tuntutan Nisbah tuntutan bersih yang kena dibayar kepada caruman terperoleh.
Claims Ratio *The ratio of net claims incurred to earned contribution income.*

Pendapatan Caruman Terperoleh Caruman bersih tolak peruntukan untuk rizab bagi caruman tidak terperoleh pada akhir tahun campur rizab bagi caruman tidak terperoleh pada awal tahun.
Earned Contribution Income *Net contributions less provision for reserves for unearned contribution (RUC) at the year-end plus the RUC at the beginning of the year.*

Rizab bagi Caruman Tidak Terperoleh Caruman yang sudah diterima bagi risiko yang belum tamat tempohnya pada akhir tempoh perakaunan.
Reserves for Unearned Contributions *Contributions already received in respect of risks which are still unexpired at the end of the accounting period.*

Takaful Am Perlindungan kepada peserta bagi kerugian akibat berlakunya malapetaka seperti kemalangan, kebakaran, banjir, liabiliti dan kecurian.
General Takaful *Protection to participant for losses arising from perils such as accident, fire, flood, liability and burglary.*

Triti Fakultatif Kontrak takaful semula yang memperuntukkan bahawa pengendali takaful yang mengesid mempunyai pilihan untuk mengesid dan pengendali takaful semula mempunyai pilihan untuk menerima atau menolak sesuatu risiko.
Facultative Treaty *A re-takaful contract under which a ceding takaful operator has the option to cede and the re-takaful operator has the option to accept or decline individual risks.*

Triti Lebihan Kerugian Sejenis triti takaful semula yang memperuntukkan bahawa pengendali takaful semula membayar semua atau peratusan yang ditentukan terhadap kerugian

yang timbul akibat kejadian atau peristiwa tertentu (sering kali berbentuk lebih hampir kepada malapetaka) melebihi amaun yang ditetapkan dan sehingga ke suatu had yang ditetapkan.
Excess of Loss Treaty *A type of re-takaful treaty which provides that the re-takaful operator pays all or a specified percentage of a loss arising from a particular occurrence or event (frequently of a more or less catastrophic nature) in excess of a fixed amount and up to a stipulated limit.*

Triti Proposional Kontrak antara pengendali takaful dengan pengendali takaful semula untuk menyertai dengan sama rata dalam pembahagian caruman dan kerugian atas setiap risiko yang tertakluk di bawah skop kontrak tersebut.
Proportional Treaty *A contract under which a takaful operator and a re-takaful operator participate proportionately in the contributions and losses on every risk that comes within the scope of the contract.*

Tuntutan Bersih Kena Dibayar Tuntutan bersih dibayar tolak peruntukan untuk tuntutan belum dibayar pada awal tahun campur peruntukan bagi tuntutan belum dibayar pada akhir tahun.
Net Claims Incurred *Net claims paid less provisions for outstanding claims at the beginning of the year plus provisions for outstanding claims at the end of the year.*

Konsep Syariah: *Shari'a concept*

Syariah Undang-undang Islam.
Shari'a *Islamic laws.*

Muamalat Jurisprudens perniagaan yang berlandaskan Syariah.
Muamalat *Islamic commercial jurisprudence.*

Mudharabah Perjanjian untuk berkongsi keuntungan dengan nisbah yang dipersetujui secara bersama antara usahawan dengan pemodal dalam perniagaan/ pelaburan. Kerugian ditanggung oleh pemodal.
Mudaraba *An agreement between the entrepreneur and the capital provider in a business venture based on a predetermined profit-sharing ratio. Losses are borne by the capital provider.*

Tabarru' Melepaskan sebahagian daripada caruman peserta sebagai derma untuk tujuan membantu sesama peserta takaful dan digunakan untuk membayar tuntutan peserta yang layak.
Tabarru' *To relinquish a portion from the contributions as a donation for fulfilling obligation of mutual help, used to pay claims submitted by eligible claimants.*

Takaful Jaminan bersama yang diberi oleh sekumpulan orang terhadap risiko tertentu atau bencana yang menimpa kehidupan seseorang, harta benda atau apa jua barangan berharga.
Takaful *Mutual guarantee provided by a group of people against a defined risk or catastrophe befalling one's life, property or any form of valuable things.*

Ta'awun Bantu-membantu ke arah kebaikan.
Ta'awun *Helping one another in furthering righteousness.*

Tijari Perniagaan yang dijalankan secara komersial.
Tijari *Commercial business.*

Wakalah Hubungan wakil/ejen dan prinsipal yang wujud apabila seseorang melantik orang lain untuk bertindak bagi pihaknya.
Wakala *Agent-principal relationship, where a person nominates another to act on his behalf.*

Defi nisi dan penjelasan di atas tidak semestinya mempunyai pengertian undang-undang kerana ianya disediakan khusus untuk maklumat pembaca yang kurang biasa dengan istilah tertentu dan sebutan yang digunakan dalam Laporan Tahunan Takaful ini

The above definitions and explanations do not necessarily bear their legal meanings as they are prepared strictly for the information of readers who are unfamiliar with certain terms and expressions used in the Takaful Annual Report

Islamic Insurance: Trends, Opportunities and the Future of Takaful

Edited by Sohail Jaffer with 19 specialist contributors

"This book is written by professionals with extensive experience of *takaful*. It will be an invaluable guide … to understanding the models and mechanisms in use and the challenges and opportunities facing the takaful market." Sarah Dingwall, Partner, Norton Rose

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